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Supreme Court of the United States.

OCTOBER TERM, 1916.

No. 286.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE,
Petitioner,

vs.

SARGENT LAND COMPANY, A CORPORATION,
Respondent.

No. 287.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE,
Petitioner,

vs.

SUTTON LAND COMPANY, A CORPORATION,
Respondent.

No. 288.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE,
Petitioner,

vs.

KEARSARGE LAND COMPANY, A CORPORATION,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth District.

Brief for Respondents.

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Brief for Respondents.

STATEMENT OF FACTS.

(Figures in parentheses refer to pages of the Transcript of Record).

These three cases come up on writs of certiorari directed to the United States Circuit Court of Appeals for the Eighth Cir-

cuit. Each case presents the same precise question as the others, and the three were tried together upon a single record. Judgments were entered in favor of the respondents in the District Court and were affirmed by the Circuit Court of Appeals (pages 40-1, 155-6).

The decision of the District Court is reported in 207 Federal Reporter, 423; that of the Circuit Court of Appeals, in 219 Federal Reporter, 31.

Nature of These Suits.

These suits demand a construction of the Corporation Excise Act of August 5, 1909. The Income Tax Law of October 3, 1913, is not here involved.

The litigation arose over the attempt of the Commissioner of Internal Revenue to exact from the respondents payment of corporation excise taxes, under the Act of August 5th, 1909, for the years 1909, 1910 and 1911, in sums aggregating more than $23,000. The action of the Commissioner was arbitrary, and, as the respondents believe, unauthorized. The respondents advised the Commissioner fully as to their status, and asserted that they were not liable to taxation under the Act, because (a) they were not organized for profit, (b) were not carrying on or doing business in the years in question, and (c) had no net income upon which, as a basis, a lawful tax could be assessed, the pecuniary receipts of the companies representing merely conversion of capital assets into money, and not income.

A prolonged correspondence extending over almost two years, together with an examination of the books and records of the respondents by an accountant appointed by the Commissioner, resulted in an order of the Commissioner in September, 1912, requiring the filing of returns by the respondents for the years 1910 and 1911, which requirement was promptly complied with. Later on, a return for the year 1909 was demanded and

was as promptly furnished. The returns so made did not accord with the Commissioner's views, and he thereupon prepared returns for the respondent companies which he required them to verify and file (which was done by them under protest), and excise taxes for the three years named were assessed against them on the basis of such returns, with a penalty of 50% added thereto for alleged delay in filing returns, although the delay was occasioned by the failure of the Commissioner to arrive at a decision regarding the respondents' taxability, until September, 1912.

Claims in abatement having been denied, the taxes were paid under protest, and an application for refundment was filed and overruled, and thereafter these suits were instituted.

Origin of Respondent Companies.

In 1890, John S. Pillsbury, George A. Pillsbury and Charles A. Pillsbury, doing business under the firm name of John S. Pillsbury & Company, were the owners of many thousand acres of lands in Northern Minnesota which had been acquired for the timber thereon, but from which the timber had been cut and removed many years before. *After the removal of the timber, the lands were valuable only for the mineral deposits if any, which might be found in them* (pages 51, 71; Decision of Court of Appeals, pages 143, 146, 148, 149, 151). In the year named they entered into an arrangement with John M. Longyear and Russell M. Bennett, pursuant to which Messrs. Longyear and Bennett were authorized to explore the lands for iron deposits under an agreement by which they should receive title to one-half of the lands which they might designate as promising to have mineral value, excepting, however, any timber which might be standing thereon, the title to which was to be reserved by the grantors (pages 51, 71; Decision of Court of Appeals, page 144). In 1892, Longyear and Bennett having discovered in the course of their explorations valuable deposits

of iron ore upon portions of these lands, an one-half interest in something over 10,000 acres was conveyed to them under the agreement, and thereafter the lands were owned as follows: John S. Pillsbury, an undivided 1/6; George A. Pillsbury, an undivided 1/6; Charles A. Pillsbury, an undivided 1/6; John M. Longyear, an undivided 1/4; and Russell M. Bennett, an undivided 1/4 (page 45; Decision of Court of Appeals, page 144).

By the year 1901, each of the partners in John S. Pillsbury & Company had died and their respective estates descended, or were devised, to numerous heirs, many of whom were minors of tender age, and in undivided interests as small as 1/108 part of the whole.

The difficulties presented by the situation are obvious (pages 45-7; Decision of District Court, page 114; Decision of Court of Appeals, page 144).

To avoid these difficulties, the three respondent companies were incorporated in February, 1906, but did not meet for organization until July 19th, 1906 (pages 62, 66).

Under the laws of Minnesota, corporations (with certain exceptions unimportant here) are prohibited from owning more than 5,000 acres of land (Gen. Stat. 1894, section 5877; Gen. Stat. 1913, section 6698; Record, page 47). In order to embrace all the lands, three corporations were therefore necessary (page 47).

Purposes of Organization.

The companies were created in order to secure a united, convenient and effectual control of the mineral properties belonging to the Pillsbury heirs and Messrs. Longyear and Bennett; to protect them against further complication by the death or marriage of any of the numerous heirs, by the transfer of some small interest to one "outside of the family" (page 46), or by the possibility of disagreements among them as to the

handling and disposition of the lands, and, especially, to provide a practical mode of partition by converting the properties into money for distribution in proportion to the several interests of the members. It was also an essential condition of the taking by the Van Buren Iron Mining Company of a mining contract (to be presently mentioned) that the contract should be executed by a corporation, because the guardian of a minor was prohibited by statute from making contracts respecting real property for a longer period than 25 years, and the period of the Van Buren contract was indeterminate (pages 46-7, 51, 52, 68-9). A glance at the articles of incorporation (which are identical in each instance, with the exception of the names of the companies and officers) will indicate the peculiar character and purpose of these companies (pages 7-12, 19-23, 31-35). The capitalization of each of the companies was fixed at $108,000 (although the value of the properties owned by each was greatly in excess of that sum), for the sole purpose of accommodating the issuance of capital stock to the smallest fractional interest held by any one of the Pillsbury heirs, and without intending to express the true worth of the capital assets; and $1,000.00 worth of stock, par value, was issued for each 1/108 owned by any of the parties (Decision of Court of Appeals, page 145).

As originally created, the general nature of the business of each of the corporations was declared to be:

> "—the buying, owning, exploring and developing, leasing, improving, selling and dealing in lands, tenements and hereditaments, and the doing of all things incidental to the things above specified." (Article I, page 8).

The stockholders of the respondent companies were desirous only of liquidating the properties conveyed to the corporations, and of converting them into money, in order that each might obtain and control his or her share in severalty (pages 48-9), and subsequently, in December, 1909, the articles of incorporation were, in each instance, amended so that Article I thereof

read, and now reads, as follows:

> "The general purpose of the corporation is to unite in one ownership the undivided, fractional interests of its various stockholders in lands, tenements and hereditaments and to own such property, and, for the convenience of its stockholders, to receive and distribute to them the proceeds of any disposition of such property, at such times, in such amounts, and in such manner as the Board of Directors may determine." (See Answers, pages 3, 15, 26; Evidence, pages 105, 106; Decision of District Court, page 117; Decision of Circuit Court of Appeals, page 145).

It appears, then, that, from the time of this amendment, the respondents *ceased to have power to engage in business*, whether for profit or otherwise (Decision of Court of Appeals, page 155).

Zonne v. Minneapolis Syndicate, 220 U. S. 187.

Unique Provisions of Charter.

The articles of incorporation of each company disclose a careful intent to pursue this declared purpose. By Article VI (identical in each case) a board of ten directors is provided for, and, in case a vacancy shall occur, a special meeting of the stockholders must be called to fill such vacancy. Article X recites the diversified ownership of the property prior to conveyance to the corporations, the division of such owners into two general classes, to-wit: the "Pillsbury heirs" on the one hand, and Messrs. Longyear and Bennett on the other, and the fact that the corporation has been formed by mutual agreement of all said owners of both classes for the more convenient handling, improvement, development and disposition of the properties; and, expressing the desire and intention of all owners that an equal voice in all matters relative to said properties shall be maintained in said two classes, provides:

> "It is hereby established as the perpetual and undeviating rule of this corporation that one-half of the entire Board of Directors of this corporation shall always be nominated by, and elected to represent, each of said two

> classes of former owners so that * * * five directors, and five only, shall be chosen by the stockholders of this corporation from nominees of 'The Pillsbury Heirs,' constituting one class, and five directors, and five only, shall be chosen by such stockholders from nominees of said Bennett and said Longyear, constituting the other class."

It is further provided in Article X that, in case a vacancy shall occur in the Board of Directors, it shall be filled by a nominee of the class by which the director whose retirement caused such vacancy was nominated.

Lest some one of the numerous owners might dispose of an interest in the properties "outside of the family," so also it was deemed desirable to restrict the ownership of the corporate stock. Accordingly, by Article VIII, any sale, assignment, transfer, hypothecation, pledge or other disposition of the capital stock of the corporation is forbidden unless the approval or consent of a majority of the Board of Directors, sitting as a Board, is first obtained.

As a further safeguard, Article IX forbids the sale or disposition of any interest in the real property except upon the affirmative vote of the holders of 75 per centum of the capital stock; and, by Article XI, no alteration, amendment or abrogation of Article X can be made except by a vote of 90 per centum of the outstanding shares of capital stock, nor can any other Article be altered, amended or abrogated except by the vote of 75 per centum of such shares.

Peculiar Nature of Properties Conveyed to the Companies.

During the lifetime of the Messrs. Pillsbury, and long prior to the incorporation of the respondent companies, the right to open mines and to extract, have, and carry away, all of the iron ore in said lands (except certain lands included in the Van Buren Company contract) had been sold to and vested in different mine operators under contracts in the form of Exhibit

15, some of which contracts are still in force (pages 71, 73, 74, 97-8; Decision of Court of Appeals, pages 146, 148). But some of the contracts, by reason of the exhaustion of the ore in the lands to which they related, were surrendered before the year 1909, and became valueless (pages 53, 71-2; Decision of Court of Appeals, page 150).

To complete an arrangement made before the organization of the corporations (pages 50-1, 68-9; Decision of Court of Appeals, pages 144, 145-6, 149), the *Sargent Land Company,* under date of January 2nd, 1907, made a similar contract with the Van Buren Iron Mining Company (Exhibit 16) covering all the remaining land which contained ore (page 59). This is the only sale of mineral made, even nominally, by any of the respondents (pages 51, 75), and it was made more than two years before the tax law was enacted.

The mode thus pursued is the customary and most effective, and substantially the only practicable way of selling iron ore in place and of converting it into money. Contracts in the form of these exhibits are commonly called "mining leases" (pages 95-6; Decision of Court of Appeals, pages 144-5).

After the death of the elder Pillsburys, and up to the incorporation of respondents, the individual owners of the lands did nothing with them except what was necessary to dispose of them and convert them into money for distribution among themselves (Decision of Court of Appeals, page 144).

The lands owned by the several companies had no value except for the minerals therein (pages 51, 71; Decision of Court of Appeals, pages 143, 146, 148, 149, 151); *all of the lands which were within the mineral range had been explored and the mineral contents thereof definitely ascertained* (pages 55, 61-2), *and all of the ore therein had been disposed of prior to the year 1909 under mineral contracts in the form shown by Exhibits 15 and 16* (pages 59, 62). In July, 1906, the various outstanding interests in the lands, including the interests which had

been acquired by Messrs. Longyear and Bennett, were conveyed to the corporations (page 66; Decision of Court of Appeals, page 145). The devolution of title, as recited herein, was admitted by the petitioner (pages 67-8).

It will thus be seen that the actual property rights conveyed by the former individual owners of the lands and acquired, as stated, by the respondent companies, were the rights or claims to receive the payments to be made under the mining contracts (Decision of Court of Appeals, pages 143, 144, 145, 146, 148, 149, 150, 151); *and that the amount of such payments receivable under the contracts was fixed without possibility of increase* (pages 74, 88, 95; Decision of District Court, page 123; Decision of Court of Appeals, *ubi supra*).

General Provisions of Mining Contracts.

All of the contracts covering the properties of the land companies, with the exception of the contract with the Van Buren Iron Mining Company, were in the same general form shown by Exhibit 15 (pages 97-8). As already stated, the contract with the Van Buren Iron Mining Company (which was the only contract executed after the organization of the companies) was in a somewhat different form but embraced substantially the same terms and conditions. This form is shown in Exhibit 16.

> [*To avoid the expense of incorporating these exhibits in the printed record, copies were transmitted to the Circuit Court of Appeals pursuant to stipulations (pages 134-6), and have been sent up to this Court*].

Each of these contracts provided, substantially, that the owners of the property (referred to as *lessors*) demised to the mine operators (designated as *lessees*), *exclusively,* all the lands covered by the respective instruments, for the purpose of exploring for, mining and removing the merchantable iron ore which might be found therein for and during a specified

period (usually 50 years) from the date of the instrument, which period was, in every case, more than sufficient to permit the extraction and shipment of all of the ore contained in the lands (Decision of Court of Appeals, pages 148, 149, 151). The lessees were given the exclusive right to occupy and control the demised premises and to erect all necessary buildings, structures and improvements thereon; the lessors, however, reserved the right to enter for the purpose of observing the operations from time to time and of measuring the amount of ore mined and removed, but in such manner as would not interfere with the work of the lessees. The lessees agreed to pay the lessors the sum (in most cases) of 25c per ton for all merchantable iron ore mined and removed from the premises, and to make such payments monthly for ore mined and shipped during the preceding month. The lessees further agreed to mine and ship a specified quantity of ore in each year and, if, for any reason, the agreed amount should not be mined and shipped, nevertheless to pay the lessors for the minimum amount so specified and to take credit therefor and apply any sums, so paid for ore not actually mined and shipped, upon ore mined and shipped thereafter in excess of such minimum (page 92; Decision of Court of Appeals, page 148).

The lessees were, in addition, to pay all taxes that might be assessed against the property during the continuance in force of the contract, and were to preserve the property free from liens or encumbrances arising through their occupancy or operation.

All ore mined and shipped was to be weighed by the Railway Company transporting the same, and reports of such weights, in the absence of disclosed errors, were to be the basis of settlement between the parties. All operations were to be carried on in accordanc with the requirements of good engineering and in a workmanlike manner and without unnecessary waste.

In case of default by the lessees in the observance of their

contract obligations, the lessors were entitled, at their election and after due notice and opportunity given to remedy the default, to terminate the contracts.

So long as the lessees should fulfill the terms of the mining contracts, the land owners (the respondent companies) could make no disposition of the iron ore, and, regardless of the market value thereof, could receive no different price therefor than the sums specified in the contracts (page 74; Decision of Court of Appeals, page 148); nor, except for the purposes of inspection of the work, could the respondents enter upon or occupy any portion of the lands or exercise any control or authority over the same (page 74).

Course of Procedure by Companies After Organization.

After organization, the corporations engaged in no activities but merely received the moneys paid to them under the various contracts relating to their lands and distributed the same to their shareholders (pages 49, 68-9; Decision of Court of Appeals, pages 144, 146).

It is claimed, however, by the Government, for the purpose of maintaining its right to impose upon them a corporation excise tax, that they engaged in activities with a view to profit, constituting a carrying on or doing business during the years 1909, 1910 and 1911. A statement respecting the activities thus relied upon by the Government is therefore necessary.

1. Sales of Platted Lands.

Before the deaths of the original Pillsbury owners and long before the organization of the corporations in 1906, three tracts, aggregating about 170 acres out of the 10,000 acres conveyed to the respondents, had been platted into town lots (pages 54, 70, 93; Decision of Court of Appeals, page 146); and, prior to the conveyance to the corporation, the exclusive

right to handle and sell the lands so platted had been vested, by contract made by the individual owners, in one Edmund J. Longyear (pages 75, 93; Decision of Court of Appeals, page 146), and the lands were received by the respondent companies subject to such contracts. From time to time since the organization of the companies, Longyear, acting under his said contract, has disposed of certain of the platted lots and paid the purchase price into the corporation holding the title to such lots (page 75; Decision of Court of Appeals, page 146). No lands have ever been platted by the companies (pages 54, 70; Decision of Court of Appeals, page 146), nor has any of the companies sold or disposed of any of the lots except such as have been sold by Longyear under said contracts (page 75).

2. Timber Sales.

Some timber (not claimed by the Pillsburys) had grown up and existed on portions of the 10,000 acres, which, at times of forest fires, was burned over and, as timber injured by fire rapidly deteriorates and becomes worthless, it was thereupon disposed of by the companies in order to save total loss (pages 85, 104-5; Decision of Court of Appeals, page 146).

3. Leasing of Lands.

Certain of the lands belonging to the corporations were squatted upon by miners working in the vicinity, and, in order to compel the speedy vacation of the premises in case the companies might have use for them, the corporation required all such squatters to take, as a condition of their occupancy, a license from the company owning the land occupied permitting such company to give summary notice of termination, and, in case of refusal of the squatter to vacate, to obtain a speedy judgment of eviction (pages 96-7; Decision of Court of Appeals, page 146). A nominal fee of $1.00 per year was charged

for such licenses. By reason of the fact that most of the land in the vicinity was underlaid with iron ore, which was being mined from open pits, so that land adjacent to the village of Hibbing is very scarce, certain tracts belonging to the Land Companies were sought by warehousemen and others for trackage purposes, and, as a favor to them and to the community, the company allowed the occupancy of these lands under similar licenses at nominal rentals aggregating, approximately, $240.00 a year. The companies also allowed the Village of Hibbing to use a tract of land as a site for a schoolhouse, as well as a considerable tract of land for a public park, for which no compensation was asked or received (page 96).

4. Acquisition of Other Land.

The only property which was ever acquired by any of the companies after their organization (other than the property conveyed to them at the outset by the Pillsbury heirs and Messrs. Longyear and Bennett) was a tract of forty acres the purchase of which had been negotiated and concluded before the organization of the companies but the conveyance of which was intentionally not executed and delivered until the organization of the companies, and, in August, 1906, title to the tract was taken in the name of the Sargent Land Company (pages 69, 70; Decision of Court of Appeals, page 146).

5. Inspection of Properties.

In order to be assured that the mining operations carried on under the contracts referred to were properly conducted, and to check reports of quantities of ore mined and removed, the respondents (the right so to do being expressly reserved in the contracts) arranged with the Meriden Iron Company,—a corporation engaged in engineering and in inspection of ore properties for others, in various localities—to provide the neces-

sary supervision and inspection of the work on the respondents' properties, for which services they paid the Meriden Company from month to month as statements therefor were rendered (pages 55, 57, 58, 59, 60-1, 63-4, 99-101).

6. Company Offices.

None of the companies has ever maintained any office, or had any salaried employees, but they have their nominal headquarters in the offices of Mr. Bennett, who is secretary and treasurer of each of the companies, and attends to the receipt and disbursement of their moneys. A certain portion of the salaries paid his office force is charged up to the different companies (page 49).

Respondents Have Never Carried on or Done Business.

Although the amendment of the articles of incorporation was not made until December, 1909, it is undisputed that, unless the facts just recited establish the contrary, none of the corporations engaged in active business of any sort during the years 1909, 1910 and 1911, and that they made no effort to engage in any enterprise for profit. They entered into no contracts; explored and developed no properties; operated no mines; made no investments, and accumulated no surplus (pages 49, 50, 51, 55, 62, 65, 68-9; Decision of Court of Appeals, pages 144, 145, 146, 147, 151, 155); they confined their operations strictly to the accomplishment of the purpose of their organization, namely, the collection of the moneys accruing under the mining contracts, the conversion into money of the properties conveyed to them by their incorporators, and the division of the proceeds, when received, among their stockholders (page 49; Decision of Court of Appeals, page 151).

The contention that respondents were carrying on business is based entirely upon the facts already recited. No testi-

mony or evidence on this subject was offered by the petitioner.

Sources of Respondents' Pecuniary Receipts.

The pecuniary receipts of the respondents during the years 1909, 1910 and 1911, were derived almost entirely from royalties paid under the mining contracts; some small amounts, however, were paid in by Edmund J. Longyear, on account of sales of lots (page 75), under the contracts which he had made during the lives of the Messrs. Pillsbury and subject to which the lands were taken over by the corporations (page 93), and some insignificant sums also accrued from the sales of timber which had been burned over and had to be disposed of in order to save a total loss, as already mentioned.

The amounts thus received, as observed by *Judge Sanborn* (pages 143, 147), were so small and insignificant as to be negligible; and the transactions out of which they were derived "were incidental to and a part of the duties of these corporations, as owners of the claims for the royalties on the ores and "of the lands, *to care for their property as owners*, and to convert it into money and to distribute the money to their stockholders" (page 146).

The petitioner and his counsel adopted the same view at the time of the trial, and in the Court of Appeals, as is demonstrated by the requests for findings and declarations of law filed at the close of the trial (page 113). No claim is based upon any receipts whatever, except receipts from royalties paid under the mining contracts.

Disposition of Corporate Receipts.

Whenever any moneys were received by the respective companies they were at once distributed by the directors to the various stockholders in pursuance of the purposes of organiza-

tion. Distributions were usually made at monthly meetings of the directors, although, occasionally, distributions were made only quarterly (pages 49, 69, 84). The custom and mode of procedure, as recorded on the books of the corporations is shown by the following excerpt from the Secretary's minute book:

> "The treasurer then presented his report in detail for the month [or months] of ..... showing total receipts, including balance on hand [at date of last report] of $.....; disbursements of $.....; leaving in the hands of the treasurer $..... Mr..... moved that a dividend of $..... per share, aggregating $....., be declared, payable immediately. The motion was duly carried, leaving in the hands of the treasurer $....." (page 97).

All of the receipts reported by the treasurer and referred to in such minutes of meetings, represented money paid into the treasury from the liquidation of the companies' assets—and nothing else. These distributions were customarily referred to as "dividends," although they embraced nothing but proceeds of sales of property (pages 69, 84, 94-5, 97; decision of Court of Appeals, page 146).

Arbitrary Assessments Made by Commissioner of Internal Revenue.

The income returns filed by the Companies under the Act of August 5th, 1909, upon requirement of the Commissioner, and which were made up by the said accountant, Mr. Schouler, representing the Treasury Department, were in form as follows (pages 107-8):

SUTTON LAND COMPANY.

1909	
Gross Income	$25,740.00
Deductions for expenses and taxes	1,948.15
Net Income	$23,791.85
Specific Deduction	5,000.00
Taxable Income	$18,791.85
Amount of Taxes Assessed	187.92
1910	
Gross Income	$24,820.00
Deductions for expenses and taxes	2,285.83
Net Income	$22,534.17
Specific Deduction	5,000.00
Taxable Income	$17,534.17
Amount of Taxes Assessed	175.34
1911	
Gross Income	$24,750.00
Deductions for expenses and taxes	2,107.50
Net Income	$22,642.50
Specific Deduction	5,000.00
Taxable Income	$17,642.50
Amount of Taxes Assessed	176.43

By a similar process of calculation the "taxable incomes" of the Kearsarge Land Company and Sargent Land Companies were arrived at by the accountant.

The "gross income" of the respective companies thus shown by Mr. Schouler represents the *entire receipts* of the companies from all sources (page 108).

While expenses and taxes were subtracted from these gross receipts, no deduction whatever was made on account of the depletion of the ore deposits on the respondents' lands resulting in a diminution of the amounts payable under the mining contracts (in which the entire substantial value of the corpor-

ate property consisted), or the extinction of other assets representing invested capital through the conveyance of lots sold, or the sale and removal of the burned timber.

It appears from the brief cross examination of the witness, *Schouler,* that he intentionally included as gross income the *gross receipts* of the companies and, after deducting the ordinary expenses, returned the balance as *net income,* from which he subtracted the statutory exemption of $5,000.00 and returned the remainder as taxable income. The witness announced it to be a fundamental principle of the Department that no claim for depreciation, diminution or depletion will be accepted unless it be evidenced by proper book entries, in reduction of the book value of the assets (pages 110, 111). *Judge Willard,* in the District Court, stated that that was a question of law to be decided by the Court and added, "—but I do not see that the not keeping of a depreciation account is at all material" (page 112).

The only difference between the returns made by the Department's accountant and the returns originally filed by the companies was in the deduction, made by the companies in their returns, for diminution or depletion of assets, which was disallowed by the Department for the reason stated by the witness (pages 110, 111).

Amounts Sought to be Recovered.

Payment of the taxes assessed, determined as above stated, was exacted by the Commissioner of Internal Revenue from the respective companies under threats of distraint and sale of their property, and was made by the companies under protest, and these actions were thereafter instituted to recover the sums so exacted, aggregating, as shown by the judgments entered for the respondents (pages 40-1), $23,321.25, upon the grounds following:

1. That the respondents were not corporations falling within the purview of the Act of August 5th, 1905, because they were not organized for profit.

2. That the respondents were not taxable under said Act, because during the years mentioned they were not carrying on or doing business.

3. That the moneys received by the respondents under the mining contracts referred to, and from the disposition of lots and timber, were not "income" within the meaning of the Act, but constituted a mere conversion of capital assets into money, without gain or profit therefrom.

4. That, if such receipts were "gross income," in whole or in part, the respondents were entitled to subtract therefrom, in order to arrive at "net income," the capital value of their properties so converted, as a deduction contemplated and permitted by the Act.

Decision in District Court, 207 Fed. 423.

The learned District Judge announced that in his opinion the respondents were corporations organized for profit (page 116), and engaged in carrying on or doing business during the years in question (pages 114-116); but he held that the receipts of the companies in said years, upon the basis of which the taxes were assessed, were in fact the *avails of the conversion into money of portions of their capital investments*, and nothing else, and were not income rendering the companies taxable under the law (page 118 *et sequitur*).

Decision of Circuit Court of Appeals, 219 Fed. 31.

The causes having been removed by the petitioner, by writs of error, to the United States Circuit Court of Appeals for the

Eighth Circuit, the judgments of the District Court were there affirmed. In so affirming them, the Court of Appeals held:

1. *That the companies were not and never have been mining companies; have never operated any mines in any way,* and are, and always have been, mere owners of the rights to collect from the lessees the fixed amount per ton of ore mined by the lessees, under mining leases of lands whose only substantial value was the value of the ore therein (page 144).

2. That the mining contracts had been made by the individual owners prior to 1907, and, if there were any gain, profit or income from the making of the contracts, that gain or income accrued before the Tax Act took effect, and the corporations are exempt from taxation on account of it (page 148).

3. That the property acquired by the corporations had no substantial value other than *the rights to collect the royalties payable under the mining contracts,* and that when the Act took effect on January 1st, 1909, and for years before that date, the corporations were the owners of the claims and rights to collect and receive the amounts which the lessees had covenanted to pay for the ore in the lands; that these things were their absolute property on January 1st, 1909; that the lands had no value to the companies in excess of the sums so covenanted to be paid by the lessees, and that none of the amounts received by the companies after January, 1909, was income, gain or profit, but was merely a different form of the respondents' property and capital (pages 148-9).

4. That a mining lease whereby the lessee is granted the absolute and exclusive right to dig for, remove and have the mineral in the land, during a term sufficiently long to enable him to remove it, is in reality a sale of the ore, and the royalties received are, in fact, the purchase price of it (page 149).

5. That, in the application of the Tax Act, the actual facts

of each individual case and their real consequences must be given effect, regardless of misleading names and forms (page 149).

6. That the sole purpose of the organization of the companies was, to collect, by means of them, the value of the rights or claims to the money accruing under the mining contracts, covering the lands conveyed to the companies, and to convert the property into money and distribute it among the grantors to the corporations (pages 150-1).

7. That the moneys received by the corporations, respectively, in the years 1909, 1910 and 1911, under the mining leases, were neither gross income nor net income, and the companies are not taxable on account of them (page 151).

8. That, if there were error in the conclusion that the receipts of the companies in the years named were not a part of their gross income, then the companies would be entitled to a "reasonable allowance for depreciation of their property" by the reduction of the value of their capital assets (represented by the rights to collect under the outstanding contracts) by the amounts of the payments received; that such payments reduced and depreciated the value of such capital assets, by the amounts paid, so that there would be no net income from them on account of which an excise tax could be lawfully exacted (page 154).

9. That the companies have not engaged in mining, trading *or any other business*, but have strictly confined their operations to the accomplishment of the purpose of their organization (pages 151-2); that corporations which are the owners of property not used in business, that engage in no trading, mining or other line of business for gain, but confine their activities to acts necessary or incidental to the protection of their property, and to the conversion of it into money, are not "do-

ing business" within the meaning of the Corporation Tax Act (page 155).

10. That the respondent companies not only so confined their operations, but, by the amendment of their articles of incorporation in the year 1909, disabled themselves from conducting any other operations, or doing any business, within the strict interpretation of the Tax Act and, therefore, were not taxable under that Act (page 155).

Petitioner's Assignments of Error.

In his statement of the facts of the case, *Judge Sanborn* said:

> "The errors assigned are: That the Court should have found and held that the *royalties* received by the companies during the years 1909, 1910 and 1911, constituted *gross income* of the companies during those years, and that the Commissioner was authorized to collect 1% thereof, without any deduction for the depreciation of the property or capital by the collection of these royalties or the conversion of parts of their capital into money and the distribution of the proceeds to the stockholders of the companies" (page 144).

At the close of the trial in the District Court, *Judge Willard,* speaking to the United States Attorney representing the petitioner (page 124), said:

> "I think, Mr. Houpt, that you should make some requests for declarations of law.
>
> *Mr. Houpt*: I would rather except to the ruling of the Court holding that *the receipt of royalties, as shown in this case, does not constitute gross income.*
>
> *The Court*: Note an exception."

Subsequently, however, the petitioner filed three requests for findings and declarations of law, appearing on page 113 of the Transcript, which were overruled and denied.

Five assignments of error were subsequently filed by petition-

er. The first three assignments of error (page 125), are to the effect that the Court erred in refusing to hold and declare the law to be as stated in the three requests respectively. The fourth assignment is that the Court erred in holding and declaring that *royalties* received by the respondents did not constitute "*gross income*" within the meaning and intent of the Act of August 5, 1909. The remaining assignment is that the Court erred in ordering and directing judgment for the respondents.

Reverting to the requests, we find that the Court was asked to declare as matters of law:

> "I. That the *royalties* paid to and received by the defendants in error [respondents here], under and pursuant to the several mining leases referred to in the evidence *constitute and are gross income* within the spirit and meaning of the corporation tax law approved August 5, 1909.
>
> 2. That the Commissioner of Internal Revenue was authorized by said Act of August 5th to assess against the defendants in error the tax mentioned in the complaints herein *upon the royalties paid to the defendants in error* for the years 1909, 1910 and 1911.
>
> 3. That plaintiff in error [petitioner here], is entitled to judgment for the taxes collected under and pursuant to the assessment made by the Commissioner of Internal Revenue, being the same taxes to recover which these actions were instituted."

It will not be controverted that an assignment of error, in order to be effectual as the foundation for a reversal of a judgment, must specify a single error and one which can be sustained as assigned.

It is palpable that the second and third requests for findings and declarations of law are open to the objection that the Court could not possibly have declared the law to be as therein requested; and the assignments of error based on the court's refusal to grant the requests are, therefore, equally futile.

The second assignment is untenable on its face, because, *first,*

"for to do this would be to attribute a different meaning to the "term 'value of the ore in place' than the parties have put upon "it, and to instruct the Circuit Court of Appeals respecting a "question about which instruction has not been requested, and "concerning which it does not even appear that any issue is "depending before that Court."

The effect of this decision is to sustain our contention that questions presented by assignments of error are to be answered *in accordance with those assignments and the requests severally referred to therein.*

The assignments of error in this case present a single theory for the consideration of the Court. They call upon the Court to state—*and to state nothing else, for they all depend upon one proposition*—that *all royalty receipts* of the respondents constitute, and are, *gross income.*

The Various Questions Presented by the Record.

The statement of facts preceding shows that these cases directly present four questions for consideration. These are:

> "1. Are the respondents corporations organized for profit?
>
> 2. Were the respondents carrying on or doing business during the years 1909, 1910 and 1911?
>
> 3. Were moneys received by the respondents during those years in payment for iron ore, under the contracts covering their mineral lands, *gross income*, or did they represent, in whole or in part, the conversion of the investment of the corporations from ore into money?
>
> 4. If such moneys were gross income, are the respondents entitled to make any deduction therefrom on account of the depletion of their capital investment?"

These questions are not complex or technical. If they did not affect internal revenue receipts, it is fair to assert that there would be no controversy regarding the correctness of the conclusions announced in the decision filed in the Circuit

Court of Appeals. The questions, nevertheless, are of large importance and it is highly desirable that a definitive determination of such of them as may properly be passed upon in these suits, should be obtained; for this reason the application of the petitioner for the writs of certiorari, by virtue of which the cases are now before this Court, met with the hearty concurrence of the respondents, and no objections to the granting of the applications were interposed.

The questions are practical and concrete. Although they arise under the Act of August 5, 1909, relating to an excise tax upon corporations, which was substantially repealed by the Income Tax Law, of October 3, 1913, they are still live and will continue to be so for some years to come. The Department of Justice is just now instituting hundreds of suits to enforce the payment of taxes claimed under the provisions of the Act of 1909, as those provisions are construed—or misconstrued—by the Department, and an authoritative interpretation of the Act will be of general advantage.

We shall take up these questions in the order in which they are above stated. If either the first or the second question be answered in the negative, the judgment before the Court must be affirmed; if both be answered in the affirmative, then the Court will be called upon to examine and determine the remaining questions and to consider those parts of this brief relating thereto.

ARGUMENT.

POINT I.

The Respondents Were Not Corporations Organized for Profit.

The language of the Act of 1909, in so far as it is of interest at this juncture, is as follows:

> "Every corporation, joint stock company, or association, (a) organized for profit, and (b) having a capital stock represented by shares, * * * (c) now or hereafter organized under the laws of the United States or of any State or Territory of the United States, * * * shall be subject to pay annually a special excise tax (d), with respect to the carrying on or doing business by such corporation, * * * equivalent to one per centum upon the entire net income over and above $5,000 received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations * * * subject to the tax hereby imposed; *provided*, however, that nothing in this section contained shall apply to labor, agricultural or horticultural organizations; or to fraternal beneficiary societies, orders or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations and dependents of such members; nor to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members; nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.
>
> Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; (second), all losses actually sustained

within the year and not compensated by insurance, or otherwise, *including a reasonable allowance for depreciation of property, if any.* * * *"

We hold these truths to be self-evident:

1. That corporations which were *not organized for profit* (whether doing business or not), were not subject to taxation under the law of 1909.

2. That corporations which *were* organized for profit were not taxable thereunder, *unless they carried on or did business during the year for which the tax was imposed.*

Therefore, unless both of the first two questions heretofore stated, can be answered in the affirmative, the third and fourth questions will not demand consideration by this Court.

As concerns the corporations which it was designed to embrace, the provisions of the Act of 1909 above quoted are not obscure. They apply to the corporations coming within the expressed conditions, and to those only. What are those conditions? They are, *first,* that a taxable corporation shall be one organized for profit; *second,* that it shall have a capital stock represented by shares; *third,* that it shall be organized under the laws of the United States, or of any state or territory, and, *fourth,* that it shall be engaged in carrying on or doing business.

Anderson v. Morris & Essex R. R. Co., 216 Fed., 83.
Lewellyn v. Pittsburgh, etc. Ry. Co., 222 Fed., 177.
Flint v. Stone-Tracy Co., 220 U. S., 107, 145, 150, 152.
Elliot v. Freeman, 220 U. S., 178.

The second and third conditions exist in the case of the respondents; the first and fourth have never existed as respects them.

The only reasonable interpretation of which the language of the Act is susceptible is, that a corporation, to be liable to

the tax, *must be carrying on or doing business for the purpose of profit,* because only by doing business of some character can a corporation make profits; and this compels these conclusions: (1) a corporation, even if organized for profit, is not taxable *if it be not carrying on or doing business;* (2) the converse of that proposition, namely, that a corporation which is carrying on or doing business is not taxable *if its activities be not directed to the making of gain;* in other words, if it be not organized for profit. The Act can only be construed as meaning that a corporation, in order to be subject to taxation thereunder, must be *organized to make profit from the carrying on or doing of business.*

In *Lewellyn v. Pittsburgh, B. & L. E. Railway Company,* 222 Fed., 177, decided by the Circuit Court of Appeals for the Third Circuit, it appeared that the Railway Company had leased its railroad, rolling stock and equipment for a long term of years and had surrendered the entire possession, operation and control thereof to its lessee, who paid the rentals directly to the various stockholders of the corporation. Having been subsequently assessed for a corporation excise tax which it paid, under protest that it was not engaged in business during the taxing period and was therefore exempt, it brought suit against the collector to recover the amount so paid. Touching the construction above urged of the Act of 1909, the Court said:

> "The plaintiff corporations were organized for profit under the laws of the state, and their capital was represented by shares, and in these particulars and to this extent at least, they were within the statute. Being organized for profit, *the statute contemplates profits to be earned and income derived from 'carrying on or doing business,'* not for the purpose of taxing their profits or income, but, first, to determine whether the corporation is within the class intended to be taxed, and, second, in order to have a means by which the tax may be calculated. * * * Now, while we make no point of the fact that in this case dividends on stock and interest on bonds were paid by the lessee company directly to the stockholders and bondholders of the plaintiff corporations, and not by the corporations

themselves, nevertheless the income so received *was not derived from railroads operated by them, but was the consideration paid for the right to exclusively possess, manage and operate the leased railroads by the lessee company. The plaintiff railroad corporations received no income from railroads operated by themselves, and expended none in the operation of railroads or for any other purpose.* Receiving no income and disbursing none, there was, of course, no gross income from which to determine net income and no means to measure an excise tax as provided by the statute. Therefore, in being without income *from operating their railroads,* the lessor railroad corporations, to this extent at least, were outside of the scope of the statute" (pages 183-4).

See also *Smith v. Anderson, L. R.,* 15 Ch. Div., 247.

Judge Willard, deciding the cases at bar in the District Court, was of the opinion that the words in the Act "organized for profit" were used to distinguish between *charitable corporations* and all others; and that any corporation organized by private persons for their own advantage and interest, and not for social, charitable, or beneficent purposes, is organized for profit.

We find it impossible to concur in this opinion.

If the Congress had really meant to impose the excise tax upon all corporations except those organized for social, charitable or benevolent purposes, it would undoubtedly have so stated, instead of resorting to the purposeful indirection and ambiguity of which such a construction of its language convicts it. And this is conclusively supported by the subsequent express exemption of just such corporations in the *proviso* at the end of the same paragraph.

The further suggestion, that any corporation organized by private persons for their own advantage or interest is organized for profit, seems likewise untenable. Such an interpretation of the wording of the law is not only extreme, but is opposed to the common and usual acceptation of the words. It would render the requirement specified by the Congress, as a precedent

condition of taxability, utterly nugatory, and would leave the Act as if it had prescribed that every corporation having a capital stock represented by shares shall be subject to the special excise tax with respect to the carrying on or doing business by such corporation; *provided*, however, that nothing in this act shall apply to labor, charitable and other corporations or associations as specified. For it is not sensibly conceivable that any persons would organize a corporation, unless it would be of some advantage to them. But "advantage" is not the word employed in the Act, the word is "profit," and that word must be construed in its general acceptation as intending gain or increase realized from business transactions.

Gray v. Darlington, 82 U. S., 63.

On the other hand, *Judge Sanborn*, delivering the opinion of the Circuit Court of Appeals, said (pages 150-1), after describing the peculiar nature of the respondent companies:

> "The proof is plenary and uncontroverted that the *sole purpose* of the owners of the claims for the royalties and purchase price of the ores and of the lands in organizing the corporations and making them the owners thereof, was to collect, by means of them, these claims, converting the property into money and distributing it among the grantors to the corporations; that this was the sole purpose of the stockholders of the corporations and their directors and officers in receiving the ownership of the property, and that the corporations have confined their operations to so converting into money and distributing the proceeds of this property. * * * Those collections were simply another form of the property of the corporations and of the stockholders substituted for the parts of the claims paid."

Again, at the bottom of page 151, *Judge Sanborn* said, with reference to the nature of the respondent companies:

> "The sole purpose of the conveyance and of their organization was to enable them to collect these claims, convert the property conveyed to them into money, and to divide the proceeds among their stockholders, and the corporations have not engaged in mining, trading or any other business, but have strictly confined their operations

to the accomplishment of that purpose."

Manifestly the term "profit" is distinct from "income," and there can be no just argument for construing the phrase "organized for profit" to mean "owning property"; nor can it be given a definition so as to embrace, in the category of corporations intended to be reached by the Act, those which, though passive, are receiving incomes from invested property but not from "carrying on or doing business."

Zonne v. Minneapolis Syndicate, 220 U. S., 187.
McCoach v. Minehill Company, 228 U. S., 295.
Flint v. Stone-Tracy Co., 220 U. S., 149, 152.

In the apt phrase of *Chief Justice Fuller* in the *Pollock Case*, 158 U. S., 625-6, property is but a fiction without the beneficial use of it; and the receipt of interest, rents or similar income therefrom is simply a concomitant of ownership.

To be "organized for profit" contemplates a definite purpose on the part of the incorporators that the aim of the company shall be to gain profit for its shareholders; and the words of the Act "corporation organized for profit" connote one formed for the "maintenance and operation" of a commercial or other business which will result in gain, and will involve the incurring of rentals, salaries, obligations and other "ordinary and necessary expenses" of an active business.

A corporation, the design of which precludes its engaging in enterprises productive of gain or profit, or of subjecting itself to the chance of incurring losses or the ordinary and necessary expenses incidental to carrying on or doing business, cannot be deemed to fall within the purview of the Act.

The Act of 1909 differed from the various Income Tax Laws which have been enacted in the United States in that it repudiated any intention of taxing *incomes*, but confined its operation wholly to embracing an excise tax with respect to carrying on or doing business by corporations organized for profit.

If the words "organized for profit" be ignored, the Act would apply to every corporation carrying on or doing business, which, concededly, it does not. The phrase cannot be disregarded any more than can be the accompanying clauses "having a capital stock represented by shares," or "carrying on or doing business." And just as it has been distinctly declared by this Court that corporations or associations which are not organized under the laws of the United States or of any State or Territory of the United States (*Eliot v. Freeman*, 220 U. S., 178, 185), or, which, however organized, are not carrying on or doing business (*Flint v. Stone-Tracy Co.*, 220 U. S. 107, 152), are exempt from taxation under the Act of 1909, so it is obvious that corporations which are not organized for profit are similarly exempt.

See in this connection the language of *Lord Justice Cotton* in *Smith v. Anderson*, quoted upon page 85 *post*.

In *Bennett v. Austin*, 81 N. Y., 308, 319, *Judge Miller*, delivering the opinion of the Court of Appeals, distinguished between rents and profits, saying:

> "The *rent* of lands or buildings is such a sum as may be paid and realized from their occupation by tenants, and is fixed and certain, while *profits* are the result of trade which is fluctuating and uncertain and dependent upon skill, care, and the nature and amount of business transacted."

So, in *People v. Board of Supervisors*, 4 Hill, 20, *Bronson*, Judge, stated:

> "It is undoubtedly true that 'profits' and 'income' are sometimes used as synonymous terms, but strictly speaking 'income' means that which comes in or is received *from any business or investment of capital*, without reference to the outgoing expenditures; while 'profits' generally means the *gain* which is made *upon any business or investment* when both receipts and payments are taken into account."

The necessary deduction from these definitions is that Congress specifically intended to embrace within the scope of the Act of 1909 only those corporations which are carrying on some business activity, or are employing their money and property in active commercial or financial enterprises pursued as a regular occupation, for the purposes of making gain above the costs, charges and expenses of so doing,—that is to say, "organized for profit."

The sole purpose of the respondents' organization was to enable the liquidation of the assets contributed, in undivided portions, by the owners, with a view to the partition of the whole and to enable them to realize the money equivalent of their respective contributions, but with no view to dealing, speculating, trading, or gain.

During the period from the creation of the corporations down to the enactment of the law, no business of any sort was attempted, and, immediately after such enactment, the articles of incorporation were so amended as to deprive the corporations of the power to do business which, while nominally possessed before, had never been exercised. But neither under the original articles nor the amended articles was there any intention of carrying on business for profit. The assets of the corporations consisted in lands valuable only for their mineral content,—except the small tracts which had been platted by the original proprietors and placed in the exclusive control of E. J. Longyear as sales agent, under contracts which attached to the premises in the hands of the respondents and which they were without power to terminate.

Of the mineral lands, all had been explored and the mineral deposits had been ascertained and delimited and disposed of, by contracts for terms of fifty years, or over, long before the Act of 1909 was ever conceived. *As a consequence, the amounts receivable by the defendants were fixed unchangeably, without the possibility of increase, in the way of profit or gain, by any*

future fluctuations of market prices or changes in property values.

All of these contracts were executed and in force before the incorporation of the defendants, except the one shown by Exhibit 16, which was made, in fact, before the incorporation, although not executed until January 2, 1907, the delay in execution being due to the circumstances that it could not be made at all unless and until the individual owners should incorporate in order to permit the making of a valid contract extending over the required period (pages 46-7, 69). All minerals having been disposed of under contract by January 2, 1907, at agreed and unchangeable prices, the capital assets of the companies were of the same value on January 1, 1909,—as of which date the excise law became effective—as on December 31st, 1912, the latest date involved in these actions, except to the extent to which the values had been reduced by payments made on the contracts meanwhile. There was manifestly, then, no opportunity for profit, even if it had been in the thought of the incorporators. That there was no such thought is sufficiently evident.

It follows that the judgments entered in these actions are right and must be affirmed. Whether doing business, or not, whether receiving net income, or not, whether otherwise entitled to deduction therefrom by way of depreciation, or not, the defendants are not subject to the special excise tax imposed by the Act of 1909, *because they are not corporations organized for profit, and, therefore, are outside the scope of the law.*

POINT II.

The Respondents Were Not Carrying on or Doing Business During the Years 1909, 1910 and 1911.

The undisputed facts disclose that, regardless of the nature of their articles of incorporation, the respondents, during the years in question, engaged in no substantial activity other than the receipt of moneys payable to them under the outstanding mining contracts and the distribution of such moneys to their stockholders.

The insignificant receipts of $240.00 per year from rentals (exacted in most cases for the purpose of protecting the respondents in the control and power of possession of their lands), of small sums derived from sales of burned timber, and of the proceeds of sale of a few platted lots, do not, as the Court of Appeals well recognized, evidence the "engaging in business" demanded as a prerequisite of taxability. Each and every of these acts was merely incidental to the ownership and protection of property, and each was directly in line with the purpose of the corporate members to accomplish the partition of the assets which they held under joint control. It is submitted that such transactions do not constitute a carrying on or doing of business within the meaning of the Act of 1909.

Whatever interpretation may be put upon the tax sought to be imposed by that Act, it is palpable that none is attempted to be laid except "with respect to carrying on or doing business," for it was only by reason of such limitation that the constitutionality of the law was sustained.

Flint v. Stone-Tracy Co., 220 U. S., 107.

Thus, at page 145:

> "It is therefore apparent, giving all the words of the statute effect, that the tax is imposed not upon the franchises of the corporation *irrespective of their use in business*, nor upon the property of the corporation, *but upon*

the doing of corporate or insurance business, and with respect to the carrying on thereof, in a sum equivalent to one per centum upon the entire net income over and above $5,000.00 received from all sources during the year; that is, when imposed in this manner, it is a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organizations of the character described. As the latter organizations share many benefits of corporate organization, it may be described generally as *a tax upon the doing of business in a corporate capacity*".

Again, at page 150:

"The Act now under consideration does not impose direct taxation upon property solely because of its ownership. * * * The *Pollock Case* construed the tax there levied as direct, because of its ownership. In the present case *the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax,* measured by the standard prescribed. The difference between the Acts is not merely nominal, but rests upon *substantial differences between the mere ownership of property and the actual doing of business in a certain way.*"

And at page 151:

"The tax under consideration, as we have construed the statute, may be described as an excise upon the particular privilege of *doing business in a corporate capacity, i. e.,* with the advantages which arise from corporate or *quasi corporate* organization. * * * As was said in the *Thomas Case,* 192 U. S. 363, the requirement to pay such taxes involves the *exercise* of privileges, and the element of absolute and unavoidable payment is lacking. *If business is not done in the manner described in the statute, no tax is payable.*"

It is asserted by the petitioner that the cases at bar fall directly within *Mitchell v. Clark Iron Company*, 220 U. S., 107, 170, and the complaint in the case is quoted from to show the similarity of their facts.

That case was one of the many embraced in the decision of *Flint v. Stone-Tracy Company*, 220 U. S., 107, the *Clark Iron Company Case* being briefly mentioned at pages 170 and 171.

While the petitioner's quotation from the bill of complaint is, of course, correct, the important point to note is, that *the question whether the Clark Iron Company was "doing business" within the meaning of the statute, was not an issue in the case.* The action was an attack upon the Act of August 5th, 1909, solely upon the ground of its unconstitutionality, as is evidenced by the averments of the complaint, taken as a whole, by the brief of the Company's counsel, and, specifically by the single assignment of error filed in the cause, which is found upon page 34 of the Transcript, and reads as follows:

> "That the decree in the above entitled cause is erroneous and against the just rights of said plaintiff for the following reason: That the demurrer of the defendants should have been overruled *for the reason that the statute referred to in the bill of complaint is unconstitutional and void for the reasons therein set forth.*"

In disposing of the *Clark Iron Company Case,* this Court made only the following reference to it:

> "The Clark Iron Company was organized under the laws of Minnesota, owns and leases ore lands for the purpose of carrying on mining operations, and receives a royalty, depending upon the quantity of ore mined" (page 170).

And, at page 171:

> "We think it is clear that corporations organized for the purpose of doing business, *and actually engaged in such activities* as * * * leasing ore lands and collecting royalties * * * are engaged in business within the meaning of this statute * * *."

It is perfectly apparent that this Court assumed that the Clark Iron Company was continuing, after the passage and approval of the Act, to make leases from time to time, an activity, which, if it existed, may be conceded to be doing business within the statute. That the Court so assumed, is abundantly shown by other cases decided at the same and later dates,

which are in direct conflict with the holding which the Government would now impute to the *Clark Iron Company Case.*

Authorities Relied Upon by Respondents.

The court did not have in mind, and did not pass upon, any question as to what constituted "doing business."

The respondents submit that their exemption from liability to pay a corporate excise tax, upon the ground that they are not doing business, is demonstrated by the reasoning of many courts in the following cases:

Zonne v. Minneapolis Syndicate, 220 U. S., 187;
McCoach v. Minehill Co., 228 U. S., 295;
United States v. Whitridge, 231 U. S., 144;
United States v. Emery, Bird, Thayer Realty Co., 237 U. S., 28;
Minehill Co. v. McCoach, 192 Fed., 670;
Emery, Bird, Thayer Realty Co. v. United States, 198 Fed., 242;
Abrast Realty Co. v. Maxwell, 206 Fed., 333;
United States v. Nipissing Mines Co., 206 Fed., 431;
Wilkes-Barre Traction Co. v. Davis, 214 Fed., 511;
Anderson v. Morris & Essex R. R. Co., 216 Fed., 83;
Maxwell v. Abrast Realty Co., 218 Fed., 457;
N. Y. Central Co. v. Gill, 219 Fed., 184;
Public Service Ry. Co. v. Herold, 219 Fed., 301;
Lewellyn v. Pittsburgh Ry. Co., 222 Fed., 177;
Miller v. Snake River Co., 223 Fed., 946;
Traction Companies v. Collector, 223 Fed., 984;
Philadelphia Traction Co. v. McCoach, 224 Fed., 800;
Cambria Steel Co. v. McCoach, 225 Fed., 278;
Bryant & May v. Scott, 226 Fed., 875;
Public Service Electric Co. v. Herold, 227 Fed., 486;
Public Service Gas Co. v. Herold, 227 Fed., 496;
Public Service Ry. Co. v. Herold, 227 Fed., 500;
Waterbury Gaslight Co. v. Walsh, 228 Fed., 54;
State Line Co. v. Davis, 228 Fed., 246;
Public Service Ry. Co. v. Herold, 229 Fed., 902;
McCoach v. Continental, etc., Ry. Co., 233 Fed., 976;
People v. Sohmer, 112 N. E. Rep. (N. Y.), 181.
New York M. & N. Transportation Co. v. Anderson, 234 Fed., 590.

In all of the cases above cited it was held, contrary to the insistence of the Government, that the respective corporations were not engaged in carrying on or doing business within the meaning of the Act of 1909. In many of the cases, the facts approximated very closely those appearing here; in many of them the activities of the corporations involved were much greater than were the activities of the respondents; in all of them the corporations held annual meetings for the election of directors, had meetings of the directors for the election of officers and declaration of dividends, and performed all other acts necessary to maintain their corporate organizations and to protect the corporate properties.

A rough classification of the acts performed by the corporations in the cases cited, and claimed to constitute a doing of business, is as follows:

1. Maintaining corporate organization, collecting rents and distributing the same to stockholders:

Zonne v. Minneapolis Syndicate, 220 U. S., 187;
United States v. Emery, Bird, Thayer Realty Co., 237 U. S., 28;
Abrast Realty Co. v. Maxwell, 206 Fed., 333;
Wilkes-Barre Traction Co. v. Davis, 214 Fed., 511;
Anderson v. M. & E. R. R. Co., 216 Fed., 83;
Maxwell v. Abrast Realty Co., 218 Fed., 457;
Public Service Ry. Co. v. Herold, 219 Fed., 301;
Traction Companies v. Collector, 223 Fed., 984;
Philadelphia Traction Co. v. McCoach, 224 Fed., 800; affirmed, 233 Fed., 976;
Cambria Steel Co. v. McCoach, 225 Fed., 278;
People v. Sohmer, 112 N. E. Rep. (N. Y.), 181.
New York M. & N. Transportation Co. v. Anderson, 234 Fed., 590.

2. Receiving dividends from stock constituting practically the sole assets of the corporation, and distributing the same to stockholders:

United States v. Nipissing Mines Co., 206 Fed., 431.

3. Keeping up corporate existence, maintaining offices, paying salaries to officers and employees, voting stock owned in other corporations and receiving moneys accruing under leases and distributing the same to stockholders:

Public Service Gas Co. v. Herold, 227 Fed., ~~500~~ 496

4. Keeping up corporate existence, owning property, maintaining offices, transferring shares of capital stock, collecting rents and distributing the same in part, and investing the remainder and collecting and distributing the income therefrom:

McCoach v. Minehill Co., 228 U. S., 295;
Miller v. Snake River Co., 223 Fed., 946;
Cambria Steel Co. v. McCoach, 225 Fed., 278.

5. Making improvements upon property leased pursuant to provisions of the lease:

Miller v. Snake River Co., 223 Fed., 946.

6. Selling lands not needed by corporation or by its lessee:

Miller v. Snake River Co., 223 Fed., 946.
Traction Companies v. Collector, 223 Fed., 984.

7. Exercising the right of eminent domain in aid of lessee:

N. Y. Central Co. v. Gill, 219 Fed., 184;
Lewellyn v. Pittsburgh Ry. Co., 222 Fed., 177.

8. Paying and cancelling bonds after leasing property and retiring from business:

Miller v. Snake River Co., 223 Fed., 946.
Philadelphia Traction Co. v. McCoach, 224 Fed., 800.

9. Executing contracts to extend term of existing bonds, after leasing property and retiring from business:

Philadelphia Traction Co. v. McCoach, 224 Fed., 800; affirmed, 233 Fed., 976.

10. Issuing bonds for benefit of lessee pursuant to terms of lease:

Anderson v. M. & E. R. R. Co., 216 Fed., 83;
N. Y. Central Co. v. Gill, 219 Fed., 184;
Traction Companies v. Collector, 223 Fed., 984.

11. Assuming and paying off mortgage indebtedness after leasing property:

State Line Co. v. Davis, 228 Fed., 246.

12. Inspection of leased properties by lessor:

Public Service Gas Co. v. Herold, 227 Fed., 496;
Public Service Ry. Co. v. Herold, 227 Fed., 500.

13. Receiving and distributing principal and interest derived from the sale of corporate properties:

Bryant & May v. Scott, 226 Fed., 875.

14. Bringing injunction suits to protect leased property:

Traction Companies v. Collector, 223 Fed., 984.

In every case the question is determined not by the power to act, but by the actual activities engaged in by the corporation.

Flint v. Stone-Tracy Co., 220 U. S., 107, 145, 151;
United States v. Emery, Bird, Thayer Realty Co., 237 U. S., 28, 32;
Minehill Company v. McCoach, 192 Fed., 670, 672;
Public Service Ry. Co. v. Herold, 227 Fed., 500;
State Line Co. v. Davis, 228 Fed., 246, 249.

In each of the cases cited, with a single exception, the corporation charged with doing business, *and held by the courts not to be so engaged,* maintained independent offices, retained and paid many salaried officers and employees, were busied in various activities, brought suits for the protection of their property interests and for the benefit of their lessees, etc. But all such acts were in preservation of their rights as owners and not in the way of conducting trade, and did not subject them to taxation. The respondents were moribund in comparison with any of these, except the Bryant & May corporation.

Holding in the Cases at Bar in District Court.

In the court of first instance, *Judge Willard* was of the opinion that the respondent companies were engaged in carrying on and doing business, and, therefore, subject to the excise tax. He

distinguished (page 115) the present cases from the case of *Zonne v. Minneapolis Syndicate,* 220 U. S., 187, by the statement that, so far as the report of that case shows, the owner had nothing to do with *the management* of the business of its lessee; it had no supervision over the renting of the building, and no interest in supervising it. He adverted to the fact that the respondents here had the right to inspect work done on their lands, and that they exercised that right for the purpose of seeing that the operations were properly conducted.

This fact, in his judgment, distinguished also the *Minehill Case* and the *Nipissing Case.*

It is submitted that this attempted distinction is not warranted. The details of the contracts involved in the cases so distinguished do not appear in the reports; but we assert, without any fear of contradiction, that, even if there were not reserved to the lessors in those cases, in express terms, the right of inspection to enable them to ascertain whether their lessees were using or operating the premises involved in a proper or lawful manner, such lessors were not precluded, for that reason, from exercising the right of inspection for their own protection, or from taking such action, by legal proceedings or otherwise, as would preserve their rights and their property interests.

It will be observed that there is nothing in the mining contracts, illustrated by Exhibits 15 and 16 in these cases, which suffers, or was intended to permit, any supervision of the work carried on under the mining contracts in the sense of *managing, controlling, regulating, or otherwise taking part in it.*

Again *Judge Willard* emphasized (pages 115-6) the fact that the companies, during the three years in question, were engaged in selling real estate, in selling stumpage from some property which had been burned over, and in leasing property to squatters in order more easily to evict them. In this connection he said:

"It is true that those matters were trivial, but they indicate that the companies were constantly supervising and caring for this property. It was their business, and in fact it was necessarily their business, because there was no one else to do it. They had to take care of that part of their property which was not leased, someone had to take care of it, and they did take care of it. * * * All these things indicate, to my mind, the doing and engaging in business. It was doing the business of handling a large property, selling lots and seeing that the lessees lived up to their contracts. If that is not engaging in business, I do not know what is."

We think that the learned trial judge failed to take into consideration the distinction between carrying on and doing business, as intended by the law and as it has been defined by the courts, and the inherent right of the *owner of property to inform himself as to its nature and condition, and to protect and to conserve it*; and we contend that none of the circumstances referred to by the District Judge was susceptible of a construction demonstrating that the respondents were carrying on or doing business. Their attitude cannot be regarded in a different light from that of an individual similarly situated, and it would be an extreme contention to assert that an individual was engaged in business, merely because he should take steps to ascertain the character or value of his property, and, having disposed of a portion of it by a lease or by an executory contract of sale, should exercise his undoubted privilege and reasonable right of informing himself, from time to time, as to whether his vendee or contractee was conducting himself lawfully as respects the property involved.

The analogy between individuals and corporations in this respect has since been observed and adopted by the courts.

Abrast Realty Co. v. Maxwell, 206 Fed., 333, 335;
Traction Companies v. Collector, 223 Fed., 984, 988;
Philadelphia Traction Co. v. McCoach, 224 Fed., 800, 803;
People v. Sohmer, 112 N. E. Rep. (N. Y.), 181.

"There is helpful analogy in observing an individual. It is not usually hard to decide whether he is still 'in busi-

ness,' or has retired; and, if the latter, he does not lose that character because here and there, in the receipt of his income, he does an act of business" (223 Fed., 988).

Holding in Circuit Court of Appeals.

The Circuit Court of Appeals arrived at a different conclusion touching the activities and operations of the companies. That Court announced:

> "Again, this excise tax was imposed on corporations for doing business in a corporate capacity. It is imposed on corporations 'doing business' and on those only. Corporations that are the owners of property not used in business, that themselves engage in no trading, mining or other like business for gain, but confine their activities to acts necessary or incidental to the protection of their property and its conversion into money, are not 'doing business' within the meaning of the Corporation Tax Act. These companies were such owners during the years 1909, 1910 and 1911, and, as has been shown, they not only so confined their operations, but in 1909, by an amendment of their articles of incorporation, *they disabled themselves from conducting any other operations or doing any business* within the true interpretation of the Tax Act. They were not, therefore, taxable under that Act, and, for that reason, the judgments below were right" (page 155).

Again, in its statement of facts (at page 144), the Circuit Court of Appeals said:

> "The companies are not and never have been mining companies; they never have operated any mines in any way; they never made but one lease and the terms of that lease were agreed upon before the corporation lessor was organized, and, after its organization, it signed the legal contract on these terms. These corporations are, and always have been, *mere owners* of the rights to collect from the lessees under leases made before the corporations were organized, and of the lands leased, whose only substantial value was the value of the ore therein."

Distinction Between Mere Ownership and Care of Property and Using it in Doing Business.

The attitude and activity of the respondents toward their respective assets have never been any other than that of *mere ownership*. Such attitude or activity does not warrant the imposition of an excise tax under the Act of 1909.

Flint v. Stone-Tracy Co., 220 U. S., 107, 150;
McCoach v. Minehill Co., 228 U. S., 295, 306;
United States v. Emery, Bird, Thayer Co., 237 U. S., 28, 32;
United States v. Nipissing Mines Co., 206 Fed., 431, 433;
Lewellyn v. Pittsburgh, etc., Ry. Co., 222 Fed., 177, 185;
Miller v. Snake River Ry. Co., 223 Fed., 946, 951;
Traction Co's. v. Collector, 223 Fed., 984, 988;
Philadelphia Traction Co. v. McCoach, 224 Fed., 800, 805; affirmed, 233 Fed., 976;
Cambria Steel Co. v. McCoach, 225 Fed., 278, 282;
Public Service Ry. Co. v. Herold, 227 Fed., 500, 501.

It will be remembered that from the very beginning the respondent companies never contemplated engaging in business, but were organized for the single purpose of providing an instrumentality for dividing the properties which their stockholders owned in common and which,—by reason of their numbers, their ages and their varying locations, and the danger of added complications by deaths, marriages or transfers of individual shares—could not otherwise, except with great difficulty and embarrassing delays, be managed or disposed of. All of the property of any value had been already turned over, or agreed to be turned over, to the exclusive possession, control and profitable enjoyment of others, and all that the corporations were called upon to do was to receive the payments fixed by the contracts and distribute them to their members, and to get rid, as occasion might offer, of the odds and ends of property not covered by the mining contracts.

The respondents were merely holding companies and their intended and actual activities were connected solely with the protection and partition of the property interests of their share-

holders; they had no concern whatever with conducting or carrying on any business with a view to profit or to any other end.

The distinction between *the use of property in business* and *the mere ownership of property* is clear and well recognized.

In the *Stone-Tracy Case*, *Mr. Justice Day*, in the course of the opinion of the Court, said (at page 149):

> "The *Pollock Case* construed the tax there levied as direct because it was imposed upon property simply *because of its ownership*. In the present case the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax measured by the standard prescribed. The difference between the acts is not merely nominal, but rests *upon the substantial differences between the mere ownership of property and the actual doing of business in a certain way.*"

Obviously the words "doing business *in the designated capacity*" and "the actual doing of business *in a certain way*" refer to the provisions of the statute imposing the tax upon corporations (1) organized under the laws of the United States, or of any State or Territory of the United States, (2) which are organized for profit, and (3) which have a capital stock represented by shares.

The respondents stand before the court in the position of mere owners of property, and such ownership does not subject them to taxation. They are simply incorporated gentlemen of leisure.

There must be something more than *ownership and care of property* to constitute "doing business."

In *McCoach v. Minehill R. R. Co., supra*, the company owned and operated a railroad for many years prior to 1896, in which year it leased its entire property to the Philadelphia & Reading Railway Co. for 999 years. The Minehill Company agreed to maintain its corporate existence and powers during that period, and to exercise the same whenever needful to enable its

lessee to enjoy all demised rights and privileges relating to the leased property. Since 1896 the entire property has been controlled and operated by the Reading Company, and the Minehill Company has not carried on any business in connection with its operation. It has, however, maintained its corporate existence, and an office at which stock-books for the transfer of its shares of stock are kept; has received the annual rentals, collected interest on its bank deposits and the income derived from a contingent fund established and invested by it, and has distributed a portion of its annual income to its stockholders in dividends.

Having been compelled by the Collector of its district, to pay a corporation tax based on the rentals so received, the suit was brought to recover the amount so paid, upon the ground that the corporation was not carrying on or doing business, and the right of recovery was sustained by this Court.

Mr. Justice Pitney, in delivering the opinion of the Court, said, as respects the immediate matter which we are considering:

> "In our opinion, the mere receipt of income from property leased (*the property being used in business by the lessee and not by the lessor*) and the receipt of interest and dividends and the like, and the distribution thereof among the stockholders of the Minehill Company, *amount to no more than receiving the ordinary fruits that arise from the ownership of property.* * * * The distinction is between (a) the receipt of income from outside property or investments by a company *that is otherwise engaged in business*, in which event the investment income may be added to the business income in order to arrive at the measure of the tax; and (b) the receipt of income from property or investments by a company that is not engaged in business, *except the business of owning the property*, maintaining the investments, collecting the income, and dividing it among its stockholders. In the former case the tax is payable; in the latter not."

In *United States v. Nippissing Mines Co.*, 206 Fed., 431, the Circuit Court of Appeals for the Second Circuit, held that the decision in the *Minehill case* was decisive of that case, and added:

> "The substance of the decision was that *the receipt of the ordinary fruits incident to the ownership of property is not the doing of a corporate business.* That which the Minehill Company did with respect to its investment was what the defendant did. *We are unable to see that it was engaged in any other business than that of owning property*—shares in another corporation—collecting the dividends, and distributing its income among the stockholders."

In *Cambria Steel Company v. McCoach*, 225 Fed., 278, the court said upon this subject:

> "That the land leased to the Steel Company is not to exceed 10,000 acres, and that the Iron Company under the lease is to hold any other land which it possesses or may hereafter acquire for the purpose of supplying from time to time to the plaintiff lands and mines in lieu of lands and mines then demised, which may from time to time be surrendered to the Iron Company by the Steel Company, and that it is then to transfer the reserve lands to the Steel Company, is not material, for as to these lands it is not carrying on any business, *for mere ownership of lands does not constitute carrying on business*, neither does it derive any income therefrom by which a tax for business might be measured. The further fact that certain stocks and securities essential to the control of the water supply and supply of materials for manufacturing purposes remain in the name of the Iron Company, and the income is paid by it to the Steel Company, is not indicative of the carrying on of business."

See also, in this connection, the language quoted from the decision in *Stevens v. Hudson's Bay Co., post,* page 131.

This substantial difference between the mere ownership of property and the actual doing of business in connection with it, was overlooked by the learned District Judge, for (at page 117), referring to the amendment of the articles of incorpora-

tion of the respondent companies in 1909, he said:

> "It is true that that amendment specifically mentions only receipts of the proceeds, but *it authorizes the corporation to own property.* The power to sell the property so that the proceeds can be received is necessarily implied by the article itself. The corporation owns the property; if it is to distribute the proceeds of the sale, it must itself make the sale, for no one else can do it. This is the theory upon which the corporations have proceeded."

Effect of Amendment of Articles of Incorporation.

Returning to a consideration of the principal question—that of whether the respondents were carrying on or during business during the years here involved—we find this further statement defining *Judge Willard's* position (at page 117 of the transcript):

> "I do not myself think that the amendment of the articles of incorporation makes any difference, so far as this case is concerned. The original articles authorized the company to engage in the business of buying and selling real estate. The amended article provides as follows:
>
> > 'The general purpose of the corporation is to unite in one ownership the undivided fractional interests of its various stockholders in lands, tenements and hereditaments, and to own such property, and, for the convenience of its stockholders, to receive and distribute among them the proceeds of any disposition of such property, at such times, in such amounts and in such manner as the Board may determine.' "

Then follows immediately the excerpt from his decision last above quoted.

The amendment of the articles of incorporation in these cases conforms almost precisely in its terms, and completely in its effect, to the amendment made by the *Minneapolis Syndicate* in the *Zonne case*, 220 U. S., 187.

In that case the Minneapolis Syndicate, a corporation, being the owner of a tract of land upon which it had constructed an office building, sold the building to certain individuals acting

as trustees, and, at the same time, leased to them the land for a period of 130 years. The corporation, after the execution of the lease, amended its articles of incorporation so as to provide that "the sole purpose of the corporation shall be to hold the title to the westerly half of block eighty-seven of the town of Minneapolis, now vested in the corporation, subject to a lease thereof for a term of 130 years from January 1, 1907, and, for the convenience of its stockholders, to receive and distribute among them, from time to time, the rentals that accrue under said lease and the proceeds of any disposition of said land." Thenceforward, the corporation performed no other function than to receive the rentals accruing under the lease and to distribute them among the stockholders.

This Court determined that, with the sale and lease mentioned, the corporation had practically gone out of business in connection with its property, and thereafter was not engaged in doing business within the meaning of the Act. Its receipt and distribution of the rentals—although the corporate organization was expressly continued for that purpose—was not the carrying on of business in such wise as to subject it to the corporation tax.

We are not able to distinguish in effect between the amended articles of these respondents and the amendment of the articles of incorporation of the Minneapolis Syndicate, nor was the Circuit Court of Appeals, which held, respecting the respondents: "—by an amendment of their articles of incorporation they disabled themselves from conducting any other operations or doing any business within the true interpretation of the tax Act" (page 155). In the *Zonne case* the Solicitor General, appearing for the United States, contended that the power to receive and distribute rentals *and the proceeds of any sale that might be made of the land, implied a power of bargain and sale, and, for that reason, of carrying on and doing business,* and that the actual receipt and distribution of rentals constituted

in fact the doing of business. This contention was answered by *Mr. Justice Day* in his opinion, at pages 190-1, as follows:

> "Upon the record now presented we are of opinion that the Minneapolis Syndicate, after the demise of the property *and reorganization of the corporation,* was not engaged in doing business within the meaning of the act. It had wholly parted with the control and management of the property; its sole authority was (a) to hold the title subject to the lease for 130 years, (b) to receive and distribute the rentals which might accrue under the terms of the lease, (c) or the proceeds of any sale of the land, if it should be sold. The corporation had practically gone out of business in connection with the property, *and had disqualified itself by the terms of reorganization from any activity in respect to it.* We are of opinion that the corporation was not doing business in such wise as to make it subject to the tax imposed by the Act of 1909."

It will be observed that the amended articles of the Minneapolis Syndicate authorized the corporation (1) to own property; (2) to receive the income from the lease already made; (3) to distribute such income to its stockholders; (4), by direct implication, if not in express terms, to sell the property; and (5), explicitly, to distribute the proceeds of such sale among its stockholders. These are the things which, in the opinion of *Judge Willard,* constituted carrying on or doing business.

Abrast Realty Company v. Maxwell, 206 Fed., 333, presents a similar state of facts. The Realty Company organized as a corporation with general business powers, acquired certain real property which it leased to its stockholders, and later, Dec. 26, 1911, *amended its articles of incorporation,* so as to limit its activities to the mere ownership and rental of such property, and applied the entire rent, first, to the payment of interest on mortgage liens, and then to the payment of dividends to the stockholders.

In the opinion filed in the District Court, it was stated (page 335):

"But an examination of this record makes it appear that the Abrast Company did nothing before the 26th of December, 1911, in a different way than it did after that time, and that by the change in the certificate of incorporation it relinquished merely powers which it did not exercise and for which, therefore, it could not be taxed. *McCoach v. Minehill & Schuylkill Haven R. R. Co., supra.*

The general situation is entirely similar to that of the individuals who owned the real estate in question, and who leased it to the Abraham & Straus firm prior to the formation of the corporation. If these individuals had maintained an office for the renting of real estate, and had, in connection with that office, managed the real estate and performed all the duties connected therewith, those individuals would be held to have been in the real estate business. But if, on the other hand, they merely had title to the property, executed a lease, and had the rent paid either to a trustee for division among the owners, or directly to themselves, it would not seem that these individuals could be said to have been in business, nor to have conducted a real estate business, and the only tax upon the right to do business, or upon the business itself would have to be levied directly upon the property involved.

So the plaintiff corporation has no property right in the form of business privilege, beyond the ownership of the real estate which is liable to a direct real estate tax, and which is not taxable under the United States statute in question."

The conclusion thus announced, met with the concurrence of a majority of the judges of the Circuit Court of Appeals.

Maxwell v. Abrast Realty Co., 218 Fed., 457.

In the case of *McCoach v. Minehill Mining Company,* where the doctrine of the *Zonne case* was adhered to by this court, *Mr. Justice Day,* who wrote the unanimous opinion in the *Zonne Case*, dissented, and attention is directed to that opinion as indicating very clearly the significance to be attached to the amendment of the articles of incorporation. *Mr. Justice Day*, referring to the fact that the Minneapolis Syndicate had not only practically gone out of business, but, by the amendment of its articles, "had disqualified itself from any activity

in respect thereof, and, therefore, did not come within the scope of the Act," added, "in the present case the corporation has *not* disqualified itself from business activity," thereby evidencing his conviction that the fact of amendment constituted a material element to be considered, and created a vital distinction between the two corporations.

Manifestly, the amendment of their articles of incorporation by the respondents cannot be ignored in the determination of these cases; if they accomplish nothing else, the amendments conclusively disclosed the purpose of the respondents to refrain thereafter from carrying on or doing business.

Disqualification Otherwise to do Business also Exempts from Taxation.

It is further submitted that, by the transfer of their mineral properties to their respective lessees,—*who alone by reason of their exclusive right of possession, control and operation of the same, could thereafter carry on business in connection therewith,* by exploring and developing the mines and extracting and disposing of the ores—the respondents disqualified themselves from doing business quite as effectually as they did by the amendments of their articles of incorporation.

This was held by the Circuit Court of Appeals for the Second Circuit in *Anderson v. Morris & Essex Ry. Co.*, 216 Fed., 83. In that case the Court said (page 691):

> "The meaning of the words 'carrying on or doing business' and 'engaged in business' must be given their ordinary and natural signification, and, given that signification, the act done is not within the meaning of the statute. The lessor company was not an actively operating concern. Under the terms of this lease *the lessor corporation had practically gone out of business and was disqualified from any activity respecting the operation and managment of the railroad business which it had been incorporated to carry on.*"

It appeared that the Railroad Company had, prior to the year 1909, leased its railroad and branches and all its other properties, the consideration of the lease being the assumption by the lessee of the bonds and other obligations of the lessor and its agreement to pay the principal and interest thereon, to pay all taxes which might be imposed on the lessor, its business, income or property, and also to pay a certain annual percentage upon the capital stock of the lessor. The act referred to was the issuance of certain bonds to cover the cost of construction work done on the property by the lessee.

The decision last cited was followed by the Circuit Court of Appeals for the First Circuit in *New York Central Company v. Gill*, 219 Fed., 184, in which *Judge Putnam*, speaking for the Court, after quoting that portion of the opinion above set out, added:

> "This was a sensible interpretation of the statute and one in harmony with its general terms and purposes."

In the case of *Lewellyn v. Pittsburgh Railway Co.*, 222 Fed., 177, we find this language, at page 186:

> "It is not claimed that the plaintiff corporations, the lessors, were operating the leased roads when the taxes were assessed, and it is not denied that they had gone out of the business of transportation and *no longer received profits from the railroads otherwise than determined by the leases, nor is it denied that by the leases the plaintiff railroad companies had so placed themselves that they could not have engaged in the business of transportation over the leased lines, even had they wanted to.* In other words, the plaintiff railroad companies, the lessors, *had disqualified themselves to carry on or do the business,* either of operating, managing or conducting transportation over the leased lines."

These words are peculiarly apt when applied to the situation of the respondent companies. The absolute and exclusive possession, control and right of operation of their mineral lands had been transferred to others long before the enactment of

the corporation tax law, in consideration of the payment to the respondents, respectively, of stated sums per ton of ore removed, all taxes and expenses of every name and nature to be paid by the lessees. By the execution of these mining contracts, the respondents had so placed themselves that, had they desired to do so, they could not have engaged in the business of exploring for, mining, removing or disposing of any part of the iron ore contained in the lands; they had wholly disqualified themselves for carrying on or doing any business in connection with their properties which possessed any substantial value.

In the *Minehill case,* 228 U. S., at pages 303-4, this Court said:

> "From the facts as stated above, it is entirely clear that the Minehill Company was not, during the years of 1909 and 1910, engaged at all in the business of maintaining or operating a railroad, which was the prime object of its incorporation. This business, by the lease of 1896, it had turned over to the Reading Company. * * * The effect of * * * the lease * * * was to constitute the Reading Company the public agent for the operation of the railroad, and *to prevent* the Minehill Company from carrying on business in respect of the maintenance and operation of the railroad so long as the lease shall continue."

Likewise, in *United States v. Whitridge,* 231 U. S., 144, 149, the principle here contended for was again expressed as follows:

> "The possession and control of the receivers constituted, on the contrary, *an ouster of corporate management and control,* with the accompanying advantage and privileges."

Emery, Bird, Thayer Realty Co. v United States, 198 Fed., 242, presents a situation quite similar in its facts to *Zonne v. Minneapolis Syndicate.* Referring to that case, the District Judge said:

> "The only difference between that case and the case at bar which could possibly militate to the disadvantage of the plaintiff is, that here there has been no act of reorganization of the corporation by the terms of which it has disqualified itself from any activity in respect to the property. *But by its lease it has done so as effectively as did the Minneapolis Syndicate.* There the property was leased to trustees at a fixed sum and for a long period. In each case, the lessor has wholly parted with the control and management of the property, provided of course, the terms of the lease are observed" (page 251).

The cases at bar are even stronger than those of the *Minneapolis Syndicate* and the *Emery, Bird, Thayer Realty Co.,* for those Companies, owning their lands and at liberty to treat them as they might determine, themselves disposed of them by long term leases, and, to that extent, at least, transacted some business respecting them. The respondents, however, have never owned an unrestricted title to the lands which were conveyed to them by their stockholders, but acquired what, in the last analysis, is a mere equity—the legal title it is true, but a naked title, because the element of value in the lands had already been disposed of to others by executory contracts, and the respondents' only property right therein of value was the right to receive the moneys to be paid under those contracts by the lessees, in return for the ore which they acquired thereunder.

The Lessees, and not the Lessors, are the Corporations Engaged in Business, and Therefore Taxable.

It will be borne in mind that, under the mining contracts involved in these cases, the lessees are given the exclusive right of exploring for, mining and owning the merchantable iron ore therein for periods more than sufficient to permit the extraction and shipment of all such ore. The only right reserved by the respondents was that of entering upon the premises (not inter-

fering thereby with the enjoyment thereof by the lessees), for the purpose of observing the operations which might be carried on, and of measuring the amount of ore mined and removed (Decision of Court of Appeals, pages 148, 149, 151). As we have seen, practically the entire income of the respondent companies was derived from the moneys paid on these mining contracts as the consideration for the rights thus given to the lessees.

> "The companies are not and never have been mining "companies; they never have operated any mines in any "way (Decision of Circuit Court of Appeals, page 144); "* * * neither of the three corporations has ever bought, "explored, developed, leased or improved any lands, tene- "ments or hereditaments (*Idem*, page 145); * * * the "*lessees* extracted the ores from the lands from year to "year, and exhausted and paid in full for the ores cov- "ered by many of the leases before the Act of 1909 took "effect (*Idem*, page 146); * * * and the corporations "[respondents] have not engaged in mining, trading or any "other business (*Idem*, page 151)."

As further declared by the Circuit Court of Appeals (page 155), corporations that are the owners of property not used in business, that themselves engage in no trading, mining or other like business for gain, but confine their activities to acts necessary or incidental to the protection of their property and its conversion into money, are not doing business within the meaning of the Corporation Tax Act, and in that situation these respondents were during the years 1909, 1910 and 1911.

Equally undeniable is the fact that all of the property of the respondents which was used in business was so used *by the lessees under the mining contracts,* in the opening and developing of mines upon the premises, and the extraction and sale of ore therefrom. So doing, each of the *lessees* was subject to the corporation excise tax as being a corporation carrying on

and doing business, and in such cases, inasmuch as the law does not contemplate double taxation in respect of the same business, the respondents are exempt from the payment of an excise tax on account of the operations conducted upon their properties

Accordingly in *Minehill Co. v. McCoach,* 192 Fed., 670, *Judge McPherson* held:

> "It seems to be enough to say that the Reading Railway, and not the plaintiff, is doing the corporate business originally intrusted to the plaintiff, and presumably is also being taxed for carrying it on. It seems hardly possible that both corporations can be taxed in respect of transporting the same freight and passengers."

These conclusions were approved here (228 U. S., at page 304), this Court saying:

> "It is the Reading Company, and not the Minehill Company, that is 'doing business' as a railroad company upon the lines covered by the lease, *and is taxable because of it. The Corporation Tax Law does not contemplate double taxation in respect of the same business.*"

It was similarly held in *United States v. Whitridge,* 231 U. S., 144.

Certain lines of street railway in the City of New York were in the hands of Whitridge, as Receiver, under orders made by the United States Circuit Court in the year 1908. In the year 1911, petitions were filed in behalf of the United States praying for orders directing the Receiver to make returns of the net income of the railway corporations for the years 1909 and 1910. The petitions were denied and the order so made was affirmed by this Court, upon the ground that *the business was not being carried on by the railway corporations which had owned the land, but by the Receiver,* who, under the order of appointment had, during the years named, the exclusive possession and control of the properties.

The United States District Court for the District of New Jersey, in the case of

Public Service Railway Company v. Herold, 219 Fed., 301, came to the same conclusion. The Rapid Transit Street Railway Company, operating a railroad line in Newark, New Jersey, leased its property and franchises, in June, 1893, for a long term of years and the lessee had taken possession of, and operated, the railway line and, as required by the terms of its lease, had paid the taxes assessed against the property. The Court found that the only business done by the lessor, since the making of the lease, had been the maintenance of its corporate existence, and the collection and distribution of the rental called for by the lease, and that, following the decisions of this Court, the company was not carrying on or doing business. In the opinion it is said, at page 305:

> "It is, in effect, conceded by the defendant that, upon the facts as stated, the decision in *McCoach v. Minehill Company,* 228 U. S., 295, leads to a ruling that the Rapid Transit Street Railway Company was not engaged at all in the business of maintaining or operating a railroad, which was the real object of its incorporation. *It had turned its business over.* * * * The effect of the lease was to make the Public Service Company the public agent for the operation of the railroad while the lease existed, and *it is the Public Service Railway Company which is doing business under the provisions of the lease and may be taxable.*"

In *Lewellyn v. Pittsburgh etc. Railway Company,* 222 Fed., 177, the Railway Company had leased its railroad, its rolling stock and equipment, and had surrendered to the lessee the entire possession, operation and control thereof. In consideration therefor, the lessee company agreed to pay taxes, to pay dividends at a certain rate upon the capital stock of the lessor and to pay interest upon the bonded indebtedness. The lessor undertook to maintain its corporate existence in order to hold title to the properties leased and to exercise its power of emi-

ment domain to acquire additional property when requested by the lessee. After the execution of the lease, and during the taxing years in question, the lessor, at the request of its lessee, exercised its power of eminent domain, the properties so acquired being immediately delivered into the possession of the lessee company and used exclusively by it.

It was claimed by the Government that the exercise of this right of eminent domain constituted doing business which subjected the corporation to liability for a tax under the Act of 1909. Such tax, having been assessed, was paid by the Railway Company, and the action was brought to recover the amount so paid.

The Circuit Court of Appeals for the Third District, affirming a judgment in favor of the Railway Company, said, at page 185:

> "Having acquired and constructed the lines of railroad, the plaintiff corporations proceeded to operate them and after a time they disposed of them by lease, conveying in each instance all real and personal property within their ownership, and all rights in connection therewith which, under the law, they could convey. By disposing of the properties under the terms of the leases, the lessor railway companies parted with all control and management of the same and *the right to possess, operate and manage the railroads became vested, and exclusively vested, in the lessee.* Upon the transmutation of property, there was a contemporaneous transfer of business activities. *What the owners of the railroads had done before, the lessee of the railroads does now. The profits which before went to the owners, now go to the lessee.* All rights to direct the policy, or participate in the operation and management of the roads have been transferred to, and are now vested in, the lessee. * * * When the lessor railroad companies were requested to exercise for the lessee their power of eminent domain, and in response did the acts which it is claimed amounted to 'doing business,' their acts were purely formal, constituting the dry exercise of power, *in which no profit inured to them, their rentals being established, and in which all advantage inured to the lessee, which was the one corporation then actually doing business in the sense of operating the roads to which the*

several companies bore different relations, and which, therefore, was the one corporation liable to be taxed for the privilege of doing that business."

Still another case is *Miller v. Snake River Railway Company*, 223 Fed., 946. There the Railway Company leased the railroad owned by it to the Oregon Railroad & Navigation Company, which thereafter operated the same. All expenses of maintenance and renewal, taxes on the property, and incidental expenses were paid by the lessee. The Snake River Company, having been assessed for the year 1910, under the law of 1909, brought its action to recover the amount of the assessment which it had paid under protest, and recovered a judgment therefor. The judgment was affirmed by the Circuit Court of Appeals for the Ninth Circuit, which held that the Railway Company was not liable to be taxed, because it was not doing business during the taxing year. Concluding its opinion, the Court used this language, found upon page 951:

> "One reason for holding that the lessor was exempt from the tax in the *Minehill case* was, that the lessee company was doing the business as a railroad company upon the lines covered by the lease and was liable because of it, and the corporation tax law does not contemplate double taxation in respect to the same business. So in this case, *the business of operating the railroad during the entire taxing year, 1910, was conducted by the lessee or grantee. They were taxable because of that business, and to impose a like tax on the lessor would be double taxation, which the law does not contemplate.*"

To the same effect is the decision of the District Court for the District of Connecticut, in the case of

Waterbury Gas Light Company v. Walsh, 228 Fed., 54.

in which it is held that a gas company, which has leased its plants and other physical property for a term of years, the business for which it was incorporated being conducted by its lessee, is not carrying on or doing business within the meaning of the corporation tax act and is not subject to be taxed

therefor, although it retains its franchises and organization and receives and disburses its income, and, under the terms of the lease, bears the expense of alterations, improvements and additions to its plant made during the term, and also has, during the term, applied for and obtained from the Legislature amendments to its special charter.

In *State Line Co. v. Davis,* 228 Fed., 246, the plaintiff railway company leased its coal mine, railroad and other property but thereafter maintained an office for the transaction of business, maintained its corporate existence and organization by the annual election of directors and officers, and received an income in the shape of rental, and distributed dividends to its stockholders. It held itself in readiness to resume the operation of its properties if the leases should be violated by the lessee, and in such leases it reserved the right to remove timber and to mine everything underlying its properties except coal. It paid interest on the mortgage indebtedness assumed by it and was preparing to liquidate and settle such indebtedness. It made annual returns of income, and kept and maintained stock books for transfer of its capital stock, and for the transaction of its other business.

It was held that these acts did not constitute a doing of business so as to subject the corporation to the corporate excise tax, as *it is not the power to act but actual activities in certain directions which constitute a doing of business* (at page 249); and the corporation having leased its railroad, which was the prime object of its incorporation, was not doing business as a common carrier (at page 250):

> "It may be safely asserted that the plaintiff was not doing business as a railroad company, during the years 1909 and 1910, over the lines and upon its property covered by its lease. *The business of serving the public as a common carrier, which was the prime object of its incorporation, was turned over to its lessee. For this purpose the*

plaintiff must be regarded as out of business, and the taxes, therefore, were unlawfully imposed."

See also *United States v. Nipissing Mines Co.,* 206 Fed., 431, 433.
Wilkes-Barre Traction Co. v. Davis, 214 Fed., 511.

In *Public Service Railway Company, et al. v. Herold,* 229 Fed., 902 (a decision by the Circuit Court of Appeals for the Third Circuit embracing seventeen different cases which presented questions of the same general character), the Court said, after referring to various decisions in which the Act of 1909 had been construed:

"The substance of this construction is that the statute imposes an excise, not because of every act performed by a corporation under its incidental powers, but upon the privilege of doing and carrying on the business for which the corporation is organized; *and when the corporation ceases the conduct of such business by turning it over to be carried on by another, it ceases to be subject to the tax so long as it does no act by which the resumption of its business is to be inferred."*

It is not asserted that any business activity, if any were ever indulged in, has been resumed by the respondents since January 2, 1907; while the facts of the continuing exclusive occupation of the respondents' properties by their lessees, and the carrying on of the mining operations thereon by the lessees exclusively, are unquestioned. The only business done is that of the lessees, and they have presumably been taxed therefor.

No Tax May be Imposed Unless Business be Actually Done.

This is sufficiently established by the decision of this Court in the *Corporation Tax Cases* as shown by the excerpts from that decision quoted upon page 37, *ante.*

In the subsequent case of *McCoach v. Minehill Company*, 228 U. S., 295, the facts in which have already been stated (*ante*, page 48), the precise question presented for determination was defined by *Mr. Justice Pitney*, as follows:

> "Whether the Minehill Company is 'doing business' in the sense in which the Realty Companies concerned in *Flint v. Stone-Tracy Company*, were doing business, or had gone out of business, in substantially the same sense that the Minneapolis Syndicate had done so."

It was concluded that, by reason of the lease of its property, the Minehill Company was not engaged at all in the business of maintaining and operating a railroad, which was the prime purpose of its incorporation, and on that account was not taxable for the years named, notwithstanding the circumstances that it retained its office with numerous employees, received rentals under its lease, that it distributed only a portion of the annual rentals, and had invested, and was each year investing, the balance, with a view to producing income for the benefit of the company.

The analogy between the *Minehill case* and the instant cases is very close.

The activities of the Minehill Company were much greater than those ascribed by *Judge Willard* to the defendant companies; and if the Minehill Company were not doing business within the purview of the Act of 1909, the defendants were not.

In *Public Service Electric Company v. Herold*, 227 Fed., 486, a gas, electric and traction company leased to the plaintiff, for a long term, all of its property and franchises, except certain property which the Court deemed negligible and the franchise to be a corporation. Thereafter, the company sold certain stocks and bonds by virtue of which it controlled a portion of the leased properties, and authorized the payment of the purchase money to a trustee to be used in improvements and betterments of the remainder; it subsequently authorized the is-

suance of certain bonds and directed the proceeds thereof to be paid to the plaintiff to reimburse it for moneys expended in improvements of the leased property. Later, insurance money, accruing upon policies held by the lessor on account of damages occurring by fire to certain of the leased properties, was turned over to the lessee to enable the restoration of the damaged premises.

The District Court laid down the following general rule, which, beyond peradventure, must now be recognized as sound:

> "Without attempting to arrive at any exact definition, but adverting to some general principles which would seem to be pertinent, it may be said that, where there has been a practical surrender of all of the lessor's rights to operate and maintain, reserving the right of corporate existence, and where the use of such reserve corporate power is only for preserving the property leased, or for enabling the lessee to do such things effectually as are reasonably incidental to the preservation of the property and the enjoyment by the lessee of the rights and privileges conveyed by the terms of the lease, there is not an engagement in business by the lessor" (page 489).

The court held, however, that the lessor company had used its powers to issue bonds with detailed care, and that the proceeds derived from the bonds were used, not merely for betterments, but for extensions which were much more than mere maintenance of the property and were not "reasonably incidental to the enjoyment of the originally leased property." It was accordingly held that the plaintiff was subject to taxation and was not entitled to recover a corporation excise tax which it had paid under protest.

This and a number of other cases involving substantially similar facts were later carried to, and heard by, the Circuit Court of Appeals for the Third Circuit, and were decided together *sub nom.*

Public Service Ry. Co., et al., v. Herold, 229 Fed., 902.

The decision in the case last referred to was reversed under the following announcement of principles applicable to all of the numerous cases affected by the decision:

> "The character of corporate business intended to be taxed is described by the law only by the general expression 'carrying on or doing business.' From the beginning, therefore, the courts have been called upon to construe the law and to determine what corporate acts constitute doing business within its meaning.
>
> "It was recognized at once that certain corporate acts concern only the maintenance of corporate existence, and have no relation to the conduct of the business for which a corporation is organized, while others are done and performed solely in furtherance of that business without relation to the maintenance of the corporate entity. It was conceded that, with respect to the former, the law does not impose a tax, and with respect to the latter, it does. Between these extremes appear corporate acts partaking of the nature of business transactions, but pursued under circumstances that indicated *the performance of contractual undertakings rather than the conduct of corporate business.* Such transactions were presented for adjudication in a number of cases pending but not decided at the time judgments were entered in the cases under review. These were, therefore, not available to the trial court in aid of its conclusions. These decisions rule the cases under review, not merely because of the similarity in fact and in principle to the issues here involved, but because of the breadth of construction which the courts have given the statute.
>
> "The substance of this construction is, that *the statute imposes an excise, not because of every act performed by a corporation under its incidental powers, but upon the privilege of doing and carrying on the business for which the corporation is organized; and when the corporation ceases the conduct of such business, by turning it over to be carried on by another, it ceases to be subject to the tax so long as it does no act by which the resumption of its business is to be inferred.*"

After citing many of the authorities already referred to in this brief, the decision proceeds (at page 908):

> "A review of the reasons upon which these decisions are based would add nothing to the subject. It is therefore

sufficient to say we are of the opinion that the acts found, by the special verdicts in the cases under review, to have been done and performed by the lessor corporations were not done or performed by them in the conduct of the body or substance of the business for which they were organized and from which they had retired when they turned over their property to their lessees, but were corporate acts performed under the incidental powers of the corporations pursuant to the terms of contracts into which they had entered."

Of the cases cited in this brief which were included in this decision are:

Public Service Ry. Co. v. Herold, 219 Fed., 301;
Public Service Electric Co. v. Herold, 227 Fed., 486;
Public Service Gas Co. v. Herold, 227 Fed., 496;
Public Service Railway Co. v. Herold, 227 Fed., 500.

Distinction Between Maintaining Corporate Existence and Doing Business.

A distinction is made between what are called the *primary* and the *secondary* franchises of a corporation, and the effect upon their liability to this special excise tax of their exercise of these respective powers.

By "primary franchises" is meant the corporate powers essential to the organization of the company, the maintenance of its existence, the acquirement of the instrumentalities requisite to the due pursuit of the particular purposes of its creation, the preservation of its properties and the receipt and disbursement of its income; that is to say, keeping in order the internal affairs of a corporation. "Secondary franchises," on the other hand, are recognized as the powers employed in accomplishing, by means of the property and instrumentalities acquired to that end, the basic aim and object of the organization of a corporation designed for gainful activity; that is, the secondary franchises of a corporation are the powers used in conducting the business for which it is created.

The Circuit Court of Appeals for the Second Circuit, considering the case of *Anderson v. Morris & Essex Ry. Co.*, 216 Fed., 83, said (at page 88):

> "The fact that the lessor company, retaining its *primary* franchises of corporate existence, maintained its organization, held an annual meeting of its stockholders, elected directors and amended the by-laws, and that its board of directors held a special meeting and elected officers and appointed an executive committee, cannot be regarded as doing business within the purview of the Act, for it was simply keeping up the corporate organization, and surely no one can claim that the Act of 1909 imposes any excise tax upon the primary franchises or maintenance of the corporate organization. There was nothing in all this that involved the exercise of any of the *secondary* franchises of the corporation."

So, in *Lewellyn v. Pittsburgh Ry. Co.*, 222 Fed., 177, 184, decided by the Circuit Court of Appeals for the Third Circuit, we find:

> "It may be accepted as established that corporate acts performed by a corporation in the exercise of its *primary* franchises, as the maintenance of its corporate existence, do not constitute 'doing business' within the meaning of the statute, nor do corporate acts which relate strictly to the internal affairs of the corporation and which do not include the exercise of its *secondary* franchises. The statute therefore distinguishes between corporate acts, and discloses an intention to impose a tax for the privilege of doing only those acts which constitute 'carrying on and doing business.' * * * But it is clear that the statute, as interpreted, *distinguishes between business transactions as well as between corporate acts*, and the application of the statute to a given transaction or act, whether partly business or entirely corporate in its nature, must, after all, be determined by its character and purpose. By purchasing and condemning property the plaintiff corporations performed acts which were both corporate and business in their nature. The purpose of the acts is disclosed by what was accomplished by them. By the acts done the corporations merely acquired the instrumentalities to do the thing and to carry on the business for which they were incorporated. There is a distinction between acquiring the instrumentalities to do business and the doing of business with the instrumentalities acquired."

Again, in *Philadelphia Traction Company v. McCoach,* 224 Fed., 800, where the Traction Company leased its physical possessions to another, with the exclusive management and control thereof, and thereafter received the stipulated rentals and distributed the same to its stockholders, and, in addition, retired outstanding bonds, made agreements for the extension of certain maturing bonds, etc., in the course of the opinion holding that the company was not liable to the corporation excise tax, the court stated:

> "It will be clear to every mind that, as long as it was operating its own road, collecting fares and paying the operating expenses incurred, it was engaged in street railway business. The receipt and distribution of the income among its stockholders would of itself, to some minds, be part of the business it was doing. To other minds this would be a distinct and separate thing, not the carrying on of the business, but the sharing of the profits from the business. The distinction may be brought out by calling to mind the somewhat analogous distinction between the purposes for which a corporation is formed, or the business it is to conduct, and the incidental powers conferred upon it as necessary or helpful to the carrying out of its corporate purposes. * * * Its business purposes and its powers might be few or many, but the distinction between powers and purposes would still be clear. This is true notwithstanding that the two things overlap in the sense that among the rights given and the powers conferred, is that to engage in the designated business. * * * A corporation or individual might be doing business no matter how small the volume; but a corporation which borrowed money and issued bonds, which it had the power to do, could not be truly said to be engaged in that business, unless that was the purpose of its incorporation. The mere fact of the receipt of moneys from the income of the business is not the test. It would be forcing the meaning of the phrase to say that one was engaged in railroad business simply because his income was derived wholly from railroad investments" (pages 803-4).

After reciting the acts of the company above referred to, which it was contended constituted doing business, the Court added (page 805):

"With respect to these acts, they are nothing more than acts necessary to the existence of the corporation and the distribution of its annual income. They do not necessarily indicate, nor indeed throw any light upon, the question of whether or not the company was doing business, and do not justify such finding."

This decision was affirmed, *sub nom. McCoach v. Continental Passenger Railway Co.*, 233 Fed., 976, by the Circuit Court of Appeals for the Third Circuit.

The distinction thus emphasized is clearly illustrated by the General Statutes of Minnesota (1913), §6151, which reads:

"Every corporation formed under the provisions of this chapter shall have power:

1. To have succession by its corporate name for the time stated in its certificate of incorporation.
2. To sue and be sued in any court.
3. To have and use a common seal and alter the same at pleasure.
4. To acquire, by purchase or otherwise, and to hold, enjoy, improve, lease, incumber, and convey all real and personal property necessary to the purposes of its organization, subject to the limitations hereafter declared.
5. To elect or appoint, in such manner as it may determine, all necessary or proper officers, agents, boards and committees, to fix their compensation, and define their powers and duties.
6. To make and amend, consistently with law, by-laws providing for the management of its property and the regulation and government of its affairs.
7. To wind up and liquidate its business in the manner provided by law."

The powers thus conferred on corporations are plainly what are spoken of as their *primary* powers, or those incidental to their existence as artificial entities. Any or all of those powers may be used without "engaging in business." We must look to the purposes set forth in its Articles or charter, to discover whether a company is carrying on or doing business, and, if those purposes are active and contemplate buying, selling, manufacturing, transporting, mining, or other enterprises for

gain, their regular pursuit will probably be considered a doing of business; but, if not exercised, the possession of such powers will not be so considered.

What, Then, Constitutes "Doing Business"?

We have already seen that no tax may be imposed under the Act of 1909 unless business be actually done; that there is a substantial difference between the mere ownership of property and the doing of business in connection therewith; and that a corporation which is the owner of business property, but which has placed the possession, control and enjoyment thereof exclusively in the hands of another, is to be regarded as having gone out of business and disqualified itself from activity in respect of such properties.

In the *Flint Case, Mr. Justice Day* defined business as follows:

> " 'Business' is a very comprehensive term and expresses everything by which a person can be employed. 'That which occupies the time, attention and labor of men for the purpose of a livelihood or profit.' "

It has been sufficiently demonstrated that, as respects their *mineral bearing properties* the possession, control and enjoyment of all of which had been transferred to others long before the enactment of the Excise Law, the respondents, during the years in controversy, were not "engaged in business."

Nor did the exercise of their reserved right to inspect the operations of their lessees change the fact.

Public Service Gas Co. v. Herold, 227 Fed., 496;
Public Service Ry. Co. v. Herold, 227 Fed., 500.

It would be absurd to say that, as respects their *non-mineral properties*, the respondents were engaged in business during those years. If they were, what kind of business was it? Certainly not that of buying, selling or dealing in real property,

for the sales were only trivial and incidental, and such as were made were negotiated by Mr. Longyear under irrevocable contracts, executed by the original individual owners, giving him the exclusive and continuing right to dispose of such properties. The petty licenses issued to squatters and the two or three sales of burned timber were, of course, negligible.

The mere sale of property as an incident of ownership is not doing business.

Miller v. Snake River Co., 223 Fed., 946, 951;
Traction Companies v. Collector, 223 Fed., 984.

Neither is the receipt of principal and interest derived from such sales.

Bryant & May v. Scott, 226 Fed., 875.

Nor the receipt of rents from lands owned but not used in business.

Zonne v. Minneapolis Syndicate, 220 U. S., 187;
United States v. Emery, Bird, Thayer Realty Co., 237 U. S., 28.

Concerning the expressions in the Act of 1909, "engaged in business," "carrying on business" and "doing business," the Circuit Court of Appeals of the Third Circuit said:

> "The three expressions, either separately or connectedly, convey the idea of progressive, continued or sustained activity. 'Engaged in business' means occupied in business; employed in business. 'Carrying on business' does not mean the performance of a single, disconnected business act. It means conducting, prosecuting and continuing business by performing progressively all the acts normally incidental thereto; and likewise the expression 'doing business,' when employed as descriptive of an occupation, conveys the idea of business being done not from time to time but all the time."
>
> *Lewellyn v. Pittsburgh Ry. Co.*, 222 Fed., 177, 185.

It would appear, then, that to carry on or do business connotes employment, effort, control and direction of activity for purposes of livelihood or profit, and such activity must be

sustained and not sporadic.

> "Doing business, in a legislative sense, is that which occupies the time, attention and labor of men for the purpose of livelihood or profit; a calling for the purpose of a livelihood; * * * An undispensable criterion of business is that profit is intended."
>
> *State v. Boston Club,* 45 La. An., 585.

Plainly, the moment that the element of profit is taken into consideration as a criterion of doing business, any contention that the respondents were so engaged must instantly fall. And the few disconnected transactions in which they indulged were not only without any element of resultant profit, but were incidental acts of ownership, as in the sales of timber to secure such salvage as might be gained from the burned trees; in the issuing of leases or licenses for the occupation of lands to enable them to assert and secure their right of possession summarily and without the delays of suits in ejectment, and in the disposition of town lots through Mr. Longyear, recognizing the validity and force of his pre-existing contracts with the Pillsburys. And all of these isolated transactions were in furtherance of the express aim of the organizations of the companies, namely, to procure, as opportunity offered, a partition of the individual property interests of their stockholders.

The authorities all sustain these assertions.

> *Miller v. Snake River Valley Ry. Co.,* 223 Fed., 946 (Circuit Court of Appeals, Ninth Circuit).

The Railway Company was the owner of a line of railroad which was leased by it in 1907 to the Oregon Railroad & Navigation Company for a term of five years and was thereafter operated by the lessee. All expenses of maintenance and renewal, taxes on the property and incidental expenses were paid by the lessee, but it was entitled to retain, from the stipulated returns, the cost of permanent improvements.

The Snake River Company, while the lease was in force, main-

tained its corporate existence by holding stockholders meetings, electing directors and appointing various officers; collected the rents and income accruing under the lease and otherwise; made transfers of stock of the corporation; invested corporate funds; through the agency of its lessee constructed warehouse tracks and tracks connecting its line with that of another railroad company; considered and adopted a plan to terminate the lease, and did terminate the same, and considered selling, and voted to sell, the property, and sold the same; from the proceeds of the sale, and before the close of the taxing year, it paid off and retired its bonded indebtedness; discharged other claims against it; paid its annual corporation license tax, etc.

The action was brought by the Snake River Company to recover from Miller, Collector of Internal Revenue for the District of Oregon, a corporation excise tax for the year 1910, which had been exacted by the Collector.

It was held that the Snake River Company was not engaged in business during the year 1910 within the meaning of the Corporation Tax Act and that it was not subject to the excise tax which had been imposed.

In the opinion delivered in the Circuit Court of Appeals it is said:

> "The sole question presented by the record is: Was the Snake River Company 'engaged in business' during the tax year 1910 within the meaning of the Act?"

The Court referred to *McCoach v. Minchill Railway Company*, 228 U. S., 295, and said:

> "That decision is decisive here in so far as the mere ownership of the property, maintenance of offices, the keeping up of its corporate existence, the transfers of stock, the collection of rents and looking after investments by the lessor company is concerned.
>
> "We will now consider briefly the points of difference between the two cases from the standpoint of the Government. * * * [The Court discussed the first suggested difference relating to a wide variance in the terms of the re-

spective leases, and then proceeded as follows.] The only other distinction pointed out between the two cases is the sale of the property by the lessor and the payment of its indebtedness during the taxing year. Had the lessor been organized for the purpose of buying, selling and leasing railroads, this sale would no doubt constitute engaging in business within the meaning of the law. But we do not understand that it was organized for any such purpose and the *mere sale of its property as an incident of ownership does not bring it within the statute.* One reason for holding that the lessor was exempt from the tax in the *Minehill Case* was that the *lessee* company was doing the business as a railroad company upon the lines covered by the lease, *and was taxable because of it,* and the Corporation Tax Law does not contemplate double taxation in respect to the same business. So in this case the business of operating the railroad during the entire taxing year 1910 was conducted by the lessee or grantee. They were taxable because of that business, and to impose a like tax on the lessor would be double taxation, which the law does not contemplate."

In *Graham v. Hendricks,* 22 La. An., 524, the Court said, referring to "business":

> "It implies operations conducted with a view to the realizing of profits which come from skillful purchases, barter, speculation and sale."

So, in *Harris v. State,* 50 Ala., 127, the phrase "engaged in or carrying on business" within the meaning of the State revenue law was held to mean *to pursue an occupation or employment as a livelihood or a source of profit.*

The Supreme Court of Rhode Island has defined a "business corporation" as one engaged in financial dealings; buying and selling; traffic in general; or mercantile transactions.

Greenough v. Commissioners, 74 At. Rep. (R. I.), 785.

Traction Companies v. Collectors of Internal Revenue, 223 Fed., 984 (Circuit Court of Appeals, Sixth Circuit).

Six cases were consolidated and tried together, being cases against a Collector of Internal Revenue to recover for taxes

paid under protest, which were assessed under the Corporation Excise Tax Law. The Traction Companies were suburban railroad companies which had leased their lines to an operating company for the full term of their franchises. Thereafter the lessor companies did only what was necessary to maintain their organization; collected their rentals and disbursed them in dividends and otherwise; but, in accordance with the provisions of the leases which gave the lessee the right to sell unimportant items of property, the lessors joined in conveyances of the property so sold, and, in one case, issued to the lessee treasury stock and bonds in payment for permanent improvements made by the lessee; in another case they permitted a suit to be brought by the lessee in the name of the lessors.

It was held that the companies were not engaged in or doing business within the meaning of the Act, and were not subject to the excise tax.

In the course of the opinion of the court it is stated, after referring to the *Park Realty Company Case*, 220 U. S., 107, and *Zonne v. Minneapolis Syndicate*, 220 U. S., 187:

> "When we compare these two cases, by themselves, and as they have been interpreted in the *McCoach case*, in *United States v. Whitridge*, 231 U. S. 144, and in *United States v. Emery, Bird, Thayer Co.*, 237 U. S. 28, we think the true test of distinction must be, as applied to corporations of this class, whether they are continuing the body and substance of the business for which they were organized and in which they set out, or whether they have substantially retired from it and turned it over to another. If the latter appears, then their tax exempt status must be tested by the further query whether they have, during the critical period, done only such acts as are properly and normally incidental to the status of a mere lessor of such property or whether they have exercised their peculiar corporate franchises outside of and beyond the fair scope of that statute."

Anderson v. Morris & Essex Railroad Company, 216 Fed., 83 (Circuit Court of Appeals, Second Circuit).

The Railroad Company brought the action to recover a cor-

poration excise tax for the year 1910, exacted by the Commissioner of Internal Revenue and paid under protest. The company had leased its railway property and franchises for the whole term of its charter, the lessee having exclusive control of the property and conducting the operation of the railroad. The company, however, retained its franchise as a corporation, maintained its organization, held annual meetings of stockholders, elected directors, amended its by-laws and received and disposed of the rentals accruing under the lease. On the 31st day of December, 1910, it executed and delivered to the lessee its bonds for a considerable amount to reimburse the lessee for moneys expended by it in construction work on the railroad property of the lessor.

The court held that none of the acts referred to constituted carrying on or doing business by the lessor company.

Referring to the issues of bonds, the court said (page 91):

> "The meaning of the words 'carrying on or doing business' and 'engaged in business' must be given their ordinary and natural significance, and, given that significance the act done is not within the meaning of the statute. The lessor company was not an actively operating concern. Under the terms of this lease, the lessor corporation had practically gone out of business and was disqualified from any activity representing the operation and management of the railroad business which it had been incorporated to carry on. The issue of the bonds was an act done simply to enable the lessee to enjoy, use and exercise the property, franchises and rights which the lessee had previously demised, and did not amount to the resumption of business which the lease had transferred, or a 'doing of business' in the statutory sense."

Bryant & May v. Scott, 226 Fed., 875.

Plaintiff, a foreign corporation, had engaged in the business of manufacturing matches in the State of California, and in that connection acquired, jointly with the Diamond Match Co., a large acreage of timber land. In 1898 it sold out its business and its interest in the land to the Diamond Match

Co. under an executory contract which provided for partial payments running through a period of years, and, until such payments were made, the retention by the plaintiff of the legal title to its interest in the property as security therefor. The purchaser agreed to pay all taxes and assessments upon or against the property after the date of sale. Since that date the plaintiff engaged in no business in the State other than to maintain an agent there, designated in obedience to the requirements of the California code relative to foreign corporations, and to retain an attorney to look after and protect its rights under the contract, and to supervise the final transfer of title, which was made in 1912.

The defendant Scott, as Collector of Internal Revenue, exacted from the plaintiff payment of a corporation tax under the Act of August 5th, 1909, for the four years 1909 to 1912, both inclusive, which payment was made by plaintiff under protest, and this action was afterward brought to recover the amount so paid.

The court adverted to the holding of this court that the tax is "neither upon the franchise, the capital stock nor the income of the corporation, but is a tax upon the doing of business, with the advantages which inhere in the peculiarities of corporate or joint stock organization." *Flint v. Stone, Tracy Co.,* 220 U. S., 107, 145. It declared that this has reference to no merely sporadic or incidental acts or transactions, but to a carrying on of the business in which the corporation was organized to engage; that, under the authority of *McCoach v. Minehill Ry. Co.,* 228 U. S., 293, and *Zonne v. Minneapolis Syndicate,* 220 U. S., 187, the plaintiff was not within the act as a corporation subject to the taxes. It said (page 877):

> "The mere retention of the legal title to the property sold, as security for the purchase price, and the continuance of plaintiff's corporate capacity in the State for the protection of its rights under the contract and to receive the deferred payments of principal and interest, do not

constitute doing business in the sense of the statute. If the functions being performed by the corporations in the above cases (228 U. S. 295; 220 U. S. 187), do not constitute carrying on business, it is quite obvious that what was left to be done by the plaintiff at the time of the assessment here in question cannot be so characterized, since manifestly, there can be no well-founded distinction, so far as constituting the doing of business, between the functions of receiving and distributing to stockholders the *income* from invested funds, as in those cases, and *the receipt and distribution to the stockholders of the principal and interest derived from property sold*—that is, where, as here, the selling of the property is not in pursuance of the business for which the corporation was organized, but for the purpose of retiring therefrom. Indeed, the performance of the former functions, being more permanent, would seem to be more in the nature of carrying on business than the latter."

Accordingly, the plaintiff was held entitled to recover the payments exacted as Corporation Taxes for the years named.

The moneys received by the respondents here were of the same character as those thus passed upon. They constituted the deferred payments of proceeds of ores disposed of under contract before the excise law was enacted to exactly the same extent as did the moneys received by Bryant & May.

From the outset the respondents were practically mere *trustees* of the lands of their stockholders, holding the title for the single purpose of liquidating the property and distributing the proceeds to those entitled thereto; or, to use the illustration employed by *Judge Sanborn*, after describing the functions of the land companies (page 151):

"The reason for these acts was that the interests of the owners were undivided, that they were so numerous and of such ages and conditions that the partition of the property in kind, or by the conversion into money and the distribution of it, had become imperative, and the owners determined to effect it. Any one of these owners had the equitable right to such a partition. If one or more of them had petitioned the proper court for such relief and

> the court had appointed a receiver or master to collect the claims for the purchase price of the ore, or royalties, and to convert the property into money and distribute it among the owners according to their respective interests, could any court lawfully have held that the proceeds thus obtained were the gain, profit or income of the equitable owners? These corporations stood in the same relation to the claims for the purchase price of the ore, or the royalties, and the moneys they collected from them, and to the equitable owners of the property, their stockholders, that such receiver would have stood. In reality they received and held these claims and the moneys collected from them in trust to distribute them among the equitable owners of the property."

The position thus taken by the Circuit Court of Appeals is sustained by

People v. Sohmer, 112 N. E. Rep. (N. Y.), 181,

which was a proceeding in the Court of Appeals of the State of New York, to review, by writ of certiorari, the imposition of a tax upon a corporation assessed for the privilege of doing business in the State, it appeared that a railway company leased to the Lehigh Valley Railroad Company all its property, real and personal, and franchises, except the franchise to be a corporation, for a term of 999 years, the lessee agreeing to operate the railroad during the term, to pay the principal and interest of the lessor's bonds, and, as rental, to pay the net income to the holders of the lessor's capital stock. During the year for which the tax complained of was assessed, the lessor company did nothing in the State except to keep alive its corporate existence, holding an annual meeting of the stockholders for the election of officers, etc.

The language of the tax law was as follows:

> "For the privilege of doing business or exercising its corporate franchises in this State every corporation, joint stock company or association doing business in this state shall pay the state treasurer annually, in advance, an annual tax to be computed upon the basis of its capital stock employed during the preceding year within this State, and upon each dollar of such amount."

The Court of Appeals held that the statute must be applied as it speaks and that, in the absence of uncertain or questionable language, rules of construction cannot be invoked.

The opinion continues:

> "The appellant was not, within the year in question, doing business in this State. Its sole activity was to maintain its corporate existence. In the world of business and industry *it was merely the depositary of the naked legal title of the property and franchises* which it had acquired and demised many years prior. In case it had been an individual it would not be seriously argued, we think, that the individual was doing business. In case the appellant were a foreign corporation it would not be seriously argued, we think, that it was doing business in this state."

No material difference between the language of the New York statute and that of the Corporation Excise Act of 1909, as respects the meaning of the term "carrying on or doing business," is observable.

The respondents' situation was similar to that disclosed in the case of

Smith v. Anderson, L. R., 15 Ch. Div., 247.

Under the English Companies Act of 1862, it was provided that no association or partnership of more than twenty persons should be formed for carrying on any business *that had for its object the acquisition of gain*, unless it were registered under the statute referred to. The law is not fairly distinguishable from the Act of August 5 in respect of the companies or associations to which it was applicable. Both laws were enacted with exclusive reference to companies organized for profit, carrying on business.

In the English case it appeared that a number of persons (more than twenty) had contributed money to be invested by five of their number selected by them for that purpose (referred to as trustees) in various securities bearing a high rate

of interest.

The scheme was for these five trustees to receive the income from such securities and to pay a certain part thereof to the contributors, in accordance with their respective interests, and to use the surplus in retiring at par, from time to time, the certificates which they issued showing the respective contributions of the members to the original fund, and, after all the certificates had been retired, either out of surplus income or by the sale of certain of the securities, to divide the securities remaining *pro rata* among the members.

One of the members became dissatisfied and applied to the courts to wind up the affairs of the association upon the ground that they came within the [illegible]sion of the Companies Act and that, not having been re[illegible]ereunder, the association was unlawful. *Lord* [illegible]*s* said:

> "Supposing that the c[illegible]ers did constitute an association, it appears [illegible] that it cannot, in the practical sense of the word [illegible]siness,' in any sense in which any man of business would use that word, be said that the association was formed for the purpose of *carrying on* any business, either by themselves or by an agent. * * * In my opinion, nothing that is to be done by the trustees comes within the ordinary meaning of 'business' any more than what is done by the trustees of a marriage settlement, who have large properties vested in them, and who have very extensive powers of disposing of the investments, changing the investments, and selling them, and reinvesting in other investments according to their discretion and judgment, with or without the consent of their *cestuis que trustent*. That is not a business."

In a concurring opinion, *Brett, L. J.*, said:

> "The expression 'carrying on' implies a repetition of acts and excludes the case of an association formed for doing one particular act which is never to be repeated. That series of acts is to be a series of acts which constitute business. Now the word 'business' might, in a grammatical sense, include things which no ordinary person would call business, and, inasmuch as the Legislature could not particularize every particular kind of business which

> they intended to include, they have, in order to confine the meaning of the word business, stated that it is to be a business 'that has for its object the acquisition of gain.' The association, then, must be formed in order to carry on a series of acts having the acquisition of gain for their object."

He then considered the purposes of the association, concluded that the members were not associated for the purpose of speculating in shares; that there was no reason why, when they had once made an investment, it should, under ordinary circumstances, ever be changed, and announced as his opinion that the primary and substantial object of the association was not for the purpose of carrying on business, which, if successful, would result in the acquisition of gain.

Of course, the application of this decision to the cases in hand is obvious. The capital assets of the respective respondents consisted in the lands conveyed to them by their stockholders, not for the purpose of sale and investment of the proceeds in other lands with a view to pecuniary profit or other advantage, but with the exclusive design, for the convenience of the stockholders and the economical management of the property, of converting it into money which could be distributed to the stockholders in proper proportions. Such conversion cannot, in any reasonable definition of the term, be deemed carrying on or doing business, and, even if it were so considered, it is plain that no element of profit is involved in such transaction in the proper acceptation of the statutory term, which recognizes as income or profit the gain from trafficking in property in any lawful manner with a gainful purpose.

A third opinion was delivered in the case last cited by *Lord Justice Cotton.* Referring to the Companies Act, he said:

> "We have in the first part, without any reference to gain or anything else, a description of the business which com-

panies in the first part of it are formed to carry on. Then in the second part, we have a reference to companies carrying on any other business, with this qualification, that the business must be one for the acquisition of gain by the company, association or partnership, or by its members. That, in my opinion, shows that the words, 'for the purpose of carrying on any business which has for its object the acquisition of gain,' are material."

Summarizing the facts in the cases at bar, it appears without contradiction that the Land Companies were organized in 1906 without any purpose of carrying on or doing business through them, but to attain a feasible means of handling the properties conveyed to them, of collecting the moneys accruing therefrom, and of distributing the same to the individuals interested therein, the ultimate aim being to bring about a partition of such interests without sacrifice, complication or unnecessary litigation or expense. Immediately after the enactment of the Excise Law, the articles of incorporation of the respective companies were amended so as to express with unmistakable distinctness these purposes, and the intention not to engage in business.

The companies maintained no offices, employed no clerks or bookkeepers, paid no salaries; such correspondence and bookkeeping as were needful were performed by Mr. Bennett's office force, a small charge for their time devoted to such matters being paid by the companies.

The companies did not explore, develop or work any mines, or smelt or sell any ores; they did not engage in any commercial pursuits, or make any investments, or strive in any manner for gain. Their only pecuniary receipts were stated payments falling due under contracts which the corporations did not make and which they were powerless to change or terminate; and those receipts were at once divided among the stockholders in pursuance of the main object of incorporation. The stockholders met once a year to elect directors, and the direc-

tors met periodically to authorize the treasurer, by a recorded resolution, to make the distributions referred to.

No company involved in any of the decisions which have been quoted, except Bryant & May, displayed so little activity.

It plainly follows that the respondents were not taxable in the years 1909, 1910 and 1911, with respect to carrying on or doing business, because, during such years, they were not so engaged but were merely exercising the rights incident to the ownership of property. As a result, the judgments of the Circuit Court of Appeals in these cases must be affirmed.

Should it appear to the Court, however, that the respondent companies were organized for profit, and that, during the years 1909, 1910 and 1911, they were engaged in business, so that a liability to pay the special corporation excise tax attached to them, it will become necessary for the Court to investigate the nature of the pecuniary receipts of the companies and to determine, after such investigation, whether any part of them constituted gross income, and, if so, what proportion of such gross income was net income by which the amount of the tax should be measured.

We turn our attention to those subjects.

POINT III.

The Respondents Received no Gross Income During the Years 1909, 1910 and 1911.

There is no controversy whatever as to the facts in the three cases. The amount of the actual money *receipts* of each of the respondents is unquestioned. The two points of disagreement between the respondents and the Commissioner of Internal Revenue are, *first*, as to whether such money receipts

represented income at all; and, if any part were income, *second*, what deductions therefrom, in addition to expenses and taxes conceded by the Commissioner, the respondents may lawfully claim.

The first of these points of disagreement will be taken up under this subdivision.

The Respondents' Contention.

The respondents assert that the receipts of money under the mining contracts during the three years in question represented merely a conversion of capital assets without gain or profit, and were not gross income.

This assertion is clearly sustained by the admitted facts.

What are the Facts?

The three companies were created without any purpose of trading or speculating, or engaging in any business activity with a view to gain, but their organization was compelled by the peculiar conditions existing with respect to the properties which were to be vested in them.

Those conditions were: That in 1892, an undivided one-half of the properties was owned by Messrs. Longyear and Bennett, and the other one-half was owned by John S., George A. and Charles A. Pillsbury. Between that time and October 8th, 1901, each of the three Pillsburys died, leaving numerous heirs. One of them, George A. Pillsbury, died testate. The others died intestate. By the will of George A. Pillsbury, a specific interest in the properties was devised to his widow, who died in March, 1901, leaving a will by which her undivided interest (1/18 of the whole) was devised to six grandchildren, except an interest in certain of the properties which, prior to her death, she had conveyed to two other relatives (pages 45-46). After the death of Governor Pillsbury in 1901,

the Pillsbury interests were widely distributed, some of the shares being as small as 1/108 of the whole, and many of the owners were children of tender age. These Pillsbury descendants, as well as Longyear and Bennett, were anxious to realize their several interests; they resided in various parts of the United States, and no disposition of any part of the properties could be made except by the assent (directly or through guardians appointed for the various minors) of all of these heirs. None of the guardians could act in any instance except upon special application to and authorization by the Probate Court by which they were appointed, and, as will be readily conceived, to secure such authorization required, in each instance, delays of weeks and months. Consequently, opportunities to dispose of portions of the property were frequently lost through inability to act thereon promptly, and the annoyance and expense attending the disposition of any interest were intolerable.

A further consideration leading to the organization of the respondents was the fact that certain of the heirs married, thus introducing additional parties to be consulted, and whose consent must be obtained, in the persons of their spouses. Some of the heirs had children, and, in case of the death of such parties, the complications would be multiplied.

A further distinct and ever present danger existed in the possibility of some one or more of the heirs disposing of his or her undivided interest, for the purpose of realizing at once his or her inheritance in a form available for any purpose to which such heir might desire to apply it.

For all these reasons the creation of the land companies became imperative, if a sacrifice of the individual, as well as the aggregate interests was to be avoided.

Another important factor was the peculiar situation of these properties. The lands, in tracts aggregating more than 10,000 acres, had been originally selected by Messrs. Longyear and Ben-

nett as promising to have large value on account of iron deposits, the existence of such deposits on portions of the land had been definitely ascertained, and the remaining portions were selected on account of the probability of valuable mineralization thereon. Before the organization of the corporations, all of the lands upon which there was any possibility of mineral being found had been carefully explored, and the boundaries, nature and content of the iron deposits had been determined. The exclusive and irrevocable right to occupy the lands and to mine and remove the ores where ore existed, had been granted (for terms more than adequate to permit the extraction of all of the ore) by the individual owners, except as to certain tracts embraced in the Van Buren Iron Mining Co. contract, but the negotiations for this contract had begun in the year 1905 and were concluded in 1906 before the organization of the respondent companies, which occurred in July, 1906.

Recognizing not only the difficulties attaching to the execution of a mining contract by or in behalf of the "Pillsbury heirs" (and having especially in mind a statute forbidding a guardian to make any contract touching the property of his ward extending over a period in excess of twenty-five years), the Van Buren Company required, as a condition for taking the unsold ores, that the properties should be vested in a corporation by which the contract, already negotiated by the heirs and their representatives, should be executed. This contract (Exhibit 16) was finally signed and delivered by the *Sargent Land Company*, in pursuance of this arrangement, on the 2nd day of January, 1907. With its execution all of the iron ore on the properties of the respondent companies was disposed of.

The remaining non-mineral bearing properties had no substantial value, and the only substantial value in the mineral bearing properties consisted in the ores which they contained. The retention by respondents of the portions of their proper-

ties which were not leased does not affect the question, since they were not used in business.

Cambria Steel Co. v. McCoach, 225 Fed., 278.

State Line Co. v. Davis, 228 Fed., 246.

The Nature of the Property Rights Acquired by the Respondents.

What was the effect of the mining contracts as respects the property rights actually acquired by the respondents? Under the terms of the mining contracts the grantees were given the exclusive possession and control of the property, and the exclusive right to mine, ship and sell the ore as their own. All taxes and assessments were paid by them. The only rights reserved to the fee owners were, to enter upon the premises for the purposes of observing and checking up the operations carried on by their grantees, and to receive a stated price per ton for the ore, *which price remained fixed and unchangeable, regardless of any variation in the market value of the ores.*

What the corporations received, therefore, was not, in fact, the ownership of the iron ore existing upon their lands, but the rights of the former individual owners to collect, under the outstanding contracts, the moneys that should become payable on account of the ores which the contracts had disposed of.

They were in the precise situation of an individual who buys from another his farm subject to a contract of sale already made; if the vendee under the contract fulfills his obligation to pay the purchase price, at the times and in the manner provided, the purchaser from the vendor is entitled to receive such payments, and, when they are completed, is obligated to convey to the vendee the naked legal title which he has received. The moment the contract of sale was made, although the vendor remained the legal owner of the farm, the vendee became the equitable owner, and the purchaser from the vendor acquires

nothing except the vendor's rights under the outstanding contract. The value of his investment consists, manifestly, in the unpaid purchase price still due upon the contract, and, as respects the farm, his capital which it represents is the sum of those payments; as the payments are made, his capital is returned to him for re-investment in other directions, and, unless there be specific provision for payment of interest upon the unpaid instalments, it is plain that he will receive no income, gain or profit over and above the return of his invested principal.

Such, precisely, was the condition of the respondent companies when the title to their lands was conveyed to them by the "Pillsbury Heirs" and by Longyear and Bennett. While they received the legal title to the lands, they took it subject to the outstanding contracts, pursuant to the terms of which they could receive, and anticipated receiving, nothing except the moneys which should become payable thereunder.

This situation was clearly recognized by the Circuit Court of Appeals and cannot be more clearly and accurately presented than in the language of *Judge Sanborn*:

> "Thus it was that these numerous owners of undivided interests in *the claims for the moneys which the lessees had covenanted by these leases to pay for the ore in these lands,* and of the lands themselves, had become so numerous and were of such ages that it was impracticable for them to make legal contracts or conveyances, and were likely to become still more numerous (page 145). * * * So it was that when the Act of 1909 took effect these corporations were the owners *of claims against the lessees* for royalties on ores in lands in Minnesota, under leases made before that Act took effect, and of the lands themselves, which had no substantial value without the ore (page 146). * * * The lands, and hence the property of the corporations, *had no substantial value without the rights to collect the royalties the lessees had covenanted to pay.* * * * In 1906 and 1907 these corporations took from the lessors the latters' *claims and rights to collect and receive from the lessees the royalties they had covenanted to pay*

for the ore, and the title to the lands, and issued their stock therefor. * * * On January 1st, 1909, when the Act took effect, and for years before that date, these corporations were the owners *of the claims and rights to collect and receive the amounts which the lessees had covenanted by the leases to pay for the ore in the lands*, and of the lands themselves. These things were their absolute property on January 1st, 1909, and none of them was any part of their subsequent income, gain or profit. The land was practically worthless; *the rights and claims to collect the amounts the lessees had covenanted to pay for the ores were practically all there was of value in their property*, and these were worth hundreds of thousands of dollars (page 148). * * * By the leases, the owners of the land granted to the lessees the absolute and exclusive right to take out and have all the ore in the land, and to remove it at any time within twenty-five to fifty years, a time so long that it was ample to enable them to remove all of it and is equivalent to an unlimited time, and the lessees agreed to pay a yearly fixed amount per ton for all the ore they should take, and to pay the minimum amounts annually, whether the ore was taken or not, and *the result was that the lessors granted a part of the corpus of the property, that by the grant the lessees were made the owners of the ore and the lessors the owners of the claims and of the rights to collect the amounts the lessees covenanted to pay for the ores*, and the transactions were in reality sales of the ore for covenants to pay the purchase price thereof (page 149). * * * But the truth is that the leases merely *changed the form of the property of the lessors from the ores to the rights and claims to the purchase price of the ores which the lessees covenanted to pay under the name of royalties.* * * * All of the ores sold by some of the leases has already been extracted, and *the claims for its purchase price*, or royalties, have been paid in full, and the claims for them have become worthless. The ore under one of the leases was exhausted in 1911 and the claim for its purchase price, or royalties, then became worthless" (page 150).

If these conclusions be accepted—and it is difficult to perceive how their acceptance can be avoided—the judgments under review must, of course, be affirmed.

Ignoring entirely this aspect of the case, the petitioner, in Point II of his brief, lays much stress upon the following statement made, *arguendo,* by the Circuit Court of Appeals (page 149):

> "A mining lease whereby the lessee is granted the absolute and exclusive right to dig for, remove and have the mineral in the land during terms sufficiently long to enable him to remove it is in reality a sale of the ore, and the royalties reserved are in fact the purchase price of it."

Certain Pennsylvania and English cases are cited in support.

The argument advanced by petitioner upon this subject requires brief attention.

Were the Mining Contracts Sales of Ore?

A. *The Claim of Petitioner.*—The petitioner insists that they are not, and that, in consequence, the moneys received by the land-owner thereunder constitute income. If his premise be granted the conclusion does not necessarily follow.

The statement of the Circuit Court of Appeals, above quoted, is criticised as having no support outside of "the peculiar Pennsylvania cases," and Lord Blackburn is quoted (page 11 of petitioner's brief) as holding that the argument is untenable that no income tax may be imposed upon proceeds derived from mines, although they represent instalments of purchase price of minerals forming a part of the land.

The reason for this holding was found in the peculiar provisions of the English Income and *Property* Tax Act.

The act classifies the several taxes imposed into five schedules. Of these Schedules A and D are the only ones here important.

Schedule A imposes a tax upon *property* in lands, tenements and hereditaments computed upon *the annual value* thereof, and Rule 3 under Schedule A provides that such annual value

shall be computed at a sum not less than the full amount of the average profits arising therefrom during a period of five years.

Schedule D imposes a tax upon trades, occupations and businesses computed upon the "gains or profits thereof." Rule 3 under Schedule D provides that no allowance can be made, by way of diminution, "for any sum employed or intended to be employed as capital in such trade, manufacture, *adventure* or concern."

In the *Coltness case,* cited by the Court of Appeals, it was held that mines in the United Kingdom were to be assessed under Schedule A, and the question arose as to the meaning of the word "profit" as a measure of the tax. *Lord Penzance* said:

> "My Lords, the argument of the appellants was based on the interpretation which they gave to the word 'profit' in the Act. And it was contended that they could not be properly said to have made any profit out of their mines until a certain portion of the cost of making the bores and sinking the pits, necessary to approach the mineral-bearing strata, were deducted.
>
> In a general, and perhaps a strict and logical sense, I think this is true. *But it is also, and equally true, I think, that the cost of the mineral strata themselves, whether they have been hired or bought, should be included in any calculation which had for its object the ascertainment of the actual profit* obtained by the company out of the entire adventure,—so much for the prime cost of the mineral bed, so much for approaches to it in the shape of pits, so much for working it and getting the mineral to the surface,—so much for getting the mineral to the market, and against all these the price obtained for the mineral sold—these would be the elements of a profit and loss account of an entire adventure of this nature. But is this the sense in which the word 'profit' is used in the Act? I think not.
>
> *The intention of the Act, it is abundantly clear, was in Schedule A to tax 'property.'*"

After speaking of a tax on a trade or business under Schedule D, *Lord Penzance* continued:

> "But when such matter as that is brought under the provisions of this Act for taxation, the wide difference between

it and the present case is at once apparent; for the merchant or trader is taxed in such a case not in respect of any 'property' which he possesses, and of which he enjoys the fruits, but only upon the profits which he realizes annually in his trade; *whereas the owner of a 'mine' is taxed in respect of that 'mine' as a fixed and realized 'property'* which belongs to him, and from which he reaps an annual benefit; and the words 'annual value' or 'profit received' from that 'property,' are introduced into the statute, ***not*** *as the subject of taxation*, but only as *the measure of the taxation* to which the '*property*' shall be subjected."

Lord Blackburn referred to a previous case, and said:

"It was said by Lord Cairns in *Gowan v. Christy*, 3 Ex. D. 23, that a lease of mines 'is not in reality a lease at all in the sense of which we speak of agricultural leases. There is no fruit; that is to say, there is no sowing and reaping in the ordinary sense of the term, and there are no periodical harvests. What we call a mineral lease is really, when properly considered, a sale out and out of a portion of the mine.'

I think this is a perfectly accurate statement. But the argument that no income tax should be imposed on what is, perhaps not quite accurately, called rent reserved on a mineral lease, *because it is a payment by instalments of the price of minerals forming part of the land*, any more than on the price paid down in one sum for the out and out purchase of the minerals forming part of the land, is, I think, untenable."

Lord Blackburn then pointed out that under Schedule A the tax was upon *property*, and reviewed the previous legislation which had always taxed the proceeds of mines, and held that this long continued practice indicated a presumable intent to continue the taxation of mine proceeds.

The corporation excise tax is not a property tax, as this Court has specifically declared, nor has there been any federal legislation to control the interpretation of the law.

The English Act was again under consideration in *Alianza Company v. Bell*, 73 Law Journal (K. B.) 755. In that case an English Company owned caliche, or nitrate, beds in South

America. It was claimed that the company was assessable under Schedule D and that, in ascertaining the profits under that schedule, the actual cost of the materials worked up into the finished product should be deducted from the sales price.

Channel J.:—"In this country it is quite clear that the mine owner pays upon what he gets out of the mine, less, of course, the current expenses of getting it, but without any allowance for the original cost price to him of the mine, and without any regard to the fact that he is exhausting the source of income and that it may come to an end next year. * * *

Now in the case of properties abroad, *Schedule D* and not Schedule A applies. It is said, and with a certain amount of plausibility and quite accurately, in my view, as to certain concerns, that the profits or gains of a concern which obtains its money by selling articles, cannot be ascertained unless the cost price of the raw material which produces those articles which are so sold, is taken into account. As a general proposition that is, of course, absolutely correct. * * *

Under Schedule D there are certain rules by which the profits are to be ascertained, and, as I have already said, it may be that those are conventional rules for ascertaining a sum which the Income Tax Act of 1842 calls profits, but which really is not, in the proper sense, profits; * * * but still, for the purpose of the Income Tax, the conventional rule would have to be followed."

The Court then turns to the mine in question, and says:

"If an adventure deals with a particular deposit like a seam of coal or a bed of brick earth, and if the concern or company whose business or adventure is being assessed is a company to work out that deposit and turn it into money, *then it is the capital of that business. The bed of stuff is bought with their capital and is capital.* It is capital with which they are going to carry on the business, which is the turning of that into a profitable commodity, and selling the profitable commodity. * * *

The rule is that no allowance must be made in respect of capital. * * * There is not to be any allowance 'for any sum employed or intended to be employed as capital in such trade, manufacture, adventure or concern' (rule 3). * * * Where a company works a mine, it seems to me that the mine or stock of ore, or whatever is in it, is its capital, with which it starts, and no deduction for

> diminution of capital can be allowed. * * *
> The ground of my decision is that in the particular company with which I am dealing this is an exhaustion of capital, and that exhaustion of capital is not a subject for which deduction can be made *under the Income Tax Act.*"

Upon that ground the case was affirmed in the Court of Appeals in 74 Law Journal (K. B.), 219, and in the House of Lords, 75 Law Journal (K. B.), 44.

The corporation excise tax law contains no provisions similar to rule 3 of Schedule D. The unusual meaning given "profits" in the English Act can have no bearing upon the meaning of "net income" in the Act of August 5, 1909. On the other hand, our law distinctly provides for deduction on account of diminution or exhaustion of wasting capital.

> *Stratton's Independence, Limited, v. Howbert,* 231 U. S., 399, 417-18, 421.

The petitioner then quotes from the case of *Denniston v. Haddock,* 200 Pa. State, 426, to the effect that an instrument affecting ore lands will be construed like any other contract —by its own terms. This principle may be conceded. There is nothing in the case itself which seems helpful to the Government's contention, nor do we understand that they so claim. Its facts and decision have no bearing on the present inquiry and the case does not question or overrule the long line of decisions in that State holding that mineral deposits constitute a part of the real estate and are to be considered as corpus and not income.

> *Caldwell v. Fulton,* 31 Pa., 475.
> *Harlan v. Lehigh C. & N. Co.,* 35 Pa. St., 287.
> *Tiley v. Moyers,* 43 Pa. St., 404.
> *Stoughton's Appeal,* 88 Pa. St., 198.
> *Scranton v. Phillips,* 94 Pa. St., 15.
> *Eley's Appeal,* 103 Pa. St., 300.
> *Sanderson v. City of Scranton,* 105 Pa. St., 469.
> *Delaware, etc., R. R. Co. v. Sanderson,* 1 At. Rep., 394.
> *Hope's Appeal,* 3 At. Rep., 23.

Fairchild v. Fairchild, 9 At. Rep., 255.
Kingsley v. Hillsdale Iron Co., 144 Pa. St., 613.
Plumber v. Hillsdale Iron Co., 160 Pa. St., 483.
Blakely v. Marshall, 174 Pa. St., 425.
Hosack v. Crill, 204 Pa. St., 97.
Barnsdall v. Bradford Gas Co., 225 Pa. St., 338.

In the last named case the Court said:

> "The lessee is granted the possession of the land with the sole and exclusive right to mine and remove the minerals therein. In such a case, while the tenant is regarded as a lessee, *yet by the agreement he obtains title to the minerals.* * * * As also said in the *Duke case*, 107 Pa. St., 57, the whole of the oil, or only a part, may be taken under the lease; but whatever shall be taken is of the substance of the realty. * * * It will be observed that the lessee has not simply the right to the possession of the premises, but also the *title* to the oil, or such part thereof as he may be able to remove during his tenancy."

This case was followed without discussion in *Citizens' Gas Co. v. Whitney*, 232 Pa. St. 592.

Whatever name may be applied to an instrument, it is patent that, if title to real property be transferred thereunder, it is tantamount to a sale, for a sale is a contract, founded on a money consideration, by which the absolute or general property in the subject-matter is transferred from the seller to the buyer.

24 *Am. & Eng. Ency. of Law*, 1022, and cases cited in Note 1.

The authorities cited by petitioner on pages 11 and 12 of his brief do not support his contention that royalties paid for ore taken out under mining contracts constitute income. Let us look at some of them.

United States v. Gratiot, 14 Pet., 526.

Suit was brought by the United States on a bond given to insure the performance of a contract under which the United States gave the defendant permission to purchase lead ore "*from*

persons authorized to work the same," at the United States lead mines on the Upper Mississippi, in what is now the State of Illinois; to smelt such ore; to use sufficient fuel for carrying on the smelting business; and to cultivate enough land to furnish defendant's teams with provender. In return the defendant was to pay the United States six pounds of lead for every one hundred pounds smelted. The lands were public lands and the contract was made before Illinois was organized as a State.

The President had statutory power to lease these particular lead mines, and the question was certified whether he had power to make such a contract as was here involved. The court held that the contract in question constituted a lease within the President's statutory power, it being a contract for the possession of lands for carrying on smelting operations, for cutting fuel, and for cultivating for fodder.

It will be noted that the contract did not purport to dispose of any ore, but simply authorized the defendant to purchase ore from those who had already secured the right to work the mines, and to use such portions of the public land as might be necessary to carry on smelting operations and to raise fodder for animals, with the further right to cut and use needful fuel. The case therefore, does not involve the question whether the contract was a conveyance or a lease of ore in place, and certainly is not "decisive of the question," as claimed.

Hyatt v. Vincennes Bank, 113 U. S., 408.

All the mineral in a described tract was conveyed for 50 years, with the right to mine, construct necessary buildings, roads, etc., in return for specified royalties. The interest of the lessees in this contract, together with their fixtures on the land, was sold under a judicial sale conducted under the Indiana statutory requirements for the sale of real estate.

As stated by *Mr. Justice Blatchford*:

"The only question for decision is, by the stipulation

of the parties, whether the property in question should have been sold in the manner in which personal property was required by the statute of Indiana to be sold."

It was held that the lessee's interest in the land was a chattel real, which the Indiana statutes provided should be sold as real estate, the opinion concluding by the statement that it is not "intended to decide anything as to the *status* of the property, aside from the lawfulness of the manner of its sale."

Tenn. Oil Company v. Brown, 131 Fed., 696 (C. C. A. 6th Circuit).

This was a suit to remove a cloud from plaintiff's title, who claimed by conveyance from one Slaven under whom defendants also claimed the mineral interests in the land.

It seemed that Slaven, in consideration of $1.00, made an instrument selling and conveying to the defendants all the coal and other minerals, and all timber suitable for lumber, on a certain tract. The agreement required the grantee to explore for minerals and to mine them if found in sufficient quantities, paying therefor a royalty. There was no provision as to the duration of the agreement, nor when the grantee should commence mining operations. The grantee also had the right to terminate the agreement at any time. The grantee made no explorations for 15 years and Slaven thereupon conveyed the premises to the plaintiffs.

Held, that the agreement was a lease, not a conveyance, and, being terminable at the will of grantee, the grantor could also terminate it at any time. The Court, after stating that the intention of the parties governs, says that the real consideration was not the $1.00, but the thought that the mines would be explored and worked, and emphasizes the injustice that would be occasioned by holding the instrument to be a conveyance and thus giving the grantee the power to tie up the entire tract for an indefinite period in return for the $1.00 payment.

Lacey v. Newcomb, 95 Iowa, 287.

This agreement gave the exclusive right to mine coal; to use five acres of the surface for buildings; to build railroads upon and flow water over the surface, and provided a royalty for coal mined, not to fall below a certain amount per year, which should be payable as rental.

The lessee became insolvent and the lessor brought action to enforce a lien for unpaid royalties under a statute giving the landlord a lien for rent.

Held, that he was entitled to a lien upon funds in the hands of the assignee in insolvency derived from sale of insolvent's cars, railroads, etc., on the leased land.

The case goes on the theory that there was a lease of the surface and that the instrument, as regards both surface and coal, would be regarded as a lease within the benefit of the lien statute. It will be noted that one consideration was named for both surface and mineral rights which the court could not apportion, and, therefore, the lien had to be given for all or none of the amount due, and that the parties themselves designated the royalty payments as rental.

The Iowa Court has since made clear that they regard mineral deposits, or payments therefor, as corpus of the real estate, in

Hook v. Garfield Coal Company, 112 Ia., 210.

A testator's will provided:

> "I give and bequeath unto my wife, Mary T. Trash, all of my property both real and personal, and mixed, of whatever kind and wherever situated, to have and to hold as long as she may live, and to use the same for her support in any manner she chooses except she is not to sell any of the real estate I may die possessed of."

During her lifetime the widow leased certain of the land for coal mining purposes, she to receive a royalty of 10 cents per ton and the question arose as to whether she had the right

so to dispose of it. The court said:

> "The will clearly devised a life estate to Mary T. Trash. True, she had the right to use the land for her support in any manner she saw fit, but she was expressly denied the right to make a sale. The execution of the mining lease was a sale of property. The coal underneath the surface was a part of the real estate and the lease thereof, in the form in which it was executed was a transfer thereof. *Caldwell v. Fulton,* 31 Pa. State 475; Appeal of Duff, 14 At. 364; *Railway Company v. Sanderson,* 109 Pa. State, 585. * * * At that time [date of testator's death], the land was not being used for mining purposes, and there is nothing to indicate that testator intended it should be so used by the life tenant. Moreover, the will expressly negatives the idea."

Comley v. Ford, 65 W. Va., 429.

The plaintiff had granted defendant's assignor the right for 12 years to mine all coal under a certain tract and to take all necessary and convenient means for doing so, in return for which minimum royalties were to be paid. An unsealed instrument attempted to convey the lessee's interest to defendant. Defendant did not mine any coal and suit was brought against him for the minimum royalties, the defense being that there was no privity of either estate or contract between plaintiff and defendant. The defense was sustained, since defendant neither went into possession nor made any contract with the plaintiff. In regard to the assignment from the original lessee to the defendant, it appeared that, under the W. Va. statutes, no interest in lands for a period of over five years can be conveyed except by will or deed. The attempted assignment, in this case, was by an unsealed instrument which, in West Virginia, does not constitute a deed.

The doctrine that royalty payments are part of the real estate, and not income, has, however, been established in West Virginia.

Wilson v. Youst, 43 W. Va., 826.

Held, that an oil lease giving the lessee the right to remove all the oil on certain premises, in consideration of giving the lessors a certain per cent thereof, is, in legal effect, a sale of a portion of the land, and that the income derived from royalties paid under the lease goes to the life tenant, while the royalties, themselves, as corpus, go to the remainder men.

After stating that the life tenant had no right to work the oil deposit, because it had not been opened at the testator's death, the court said:

> "Oil in place under the land, as we have seen, has been held in this State to be a part of the realty and as much so as timber, coal, iron ore or salt; that it is a part of the inheritance, and an unlawful removal thereof is a disherison of him in remainder constituting waste, which a court of equity, in a proper case, will enjoin and restrain."

And in *Selvey v. Grafton Coal Co.*, 72 W. Va., 680, the Court held there was no material variance between an allegation that the plaintiffs owned certain land and proof that the plaintiffs had coal mining rights therein under an ordinary mining lease.

Gartside v. Outley, 58 Ill., 210, (cited by petitioner) is also irrelevant. After making a mortgage upon certain premises, the mortgagor executed a mining lease thereof, authorizing the lessee to mine and remove coal under the land. A breach of conditions having occurred warranting a foreclosure of the mortgage, the court held that "the foreclosure of mortgages, "and the sale thereunder, would terminate absolutely and "forever all rights of the grantee [under the lease] and his "assigns," whether the mining contract be regarded as a lease or as "conveying a higher estate."

Manning v. Frazier, 96 Ill., 279, is, however, quite in point. Where a land owner granted the coal in a tract of land at a

stipulated price per ton for the coal removed, payable quarterly, the Supreme Court said:

> "The fair and reasonable construction of the instrument, we think, is that it was a sale and conveyance of the coal in the mine on credit, and to be paid at stated intervals after coal was removed, and that the amount of each of these quarterly payments was left indefinite, and the amount to be ascertained by computation from the number of tons removed during the previous three months, at the sum named for each ton. The time for the payments to be made was not definitely fixed and the amount of each payment was left contingent, depending upon the amount removed during each period, but the money thus to be paid was purchase money for the conveyance of the coal, stone and ore."

The petitioner also cites *Austin v. Coal & Manufacturing Co.*, 72 Mo. 535. It appeared that a coal mining company took an agreement from the owner of certain land, in consideration of the fixed annual rental of $400.00, leasing and conveying to it for a term of years all the coal under the land. The company never took possession of, or entered upon, the land, and became insolvent. Some years later the defendant went upon the land and mined coal therefrom, and, when sued for the trespass by the land owner, alleged that it had settled therefor with the lessee, and pleaded such settlement as a bar, on the ground that the mining lessee was the owner of the coal. The court held that the instrument was not an absolute grant of all the coal in the land, and that mere acceptance of the contract did not vest in the lessee the property in the coal.

Ganter v. Atkinson, 35 Wis., 48.

Plaintiffs, under an oral agreement with the owner, were given the right to mine lead ores on a certain tract of land. Held, that they had such an interest in the land that they might maintain an action of trespass against third persons for mining and removing ore therefrom.

A recollection of the common law as to the rights of life tenants and remaindermen in mines, is necessary in order properly to weigh some of the cases cited by petitioner in this connection.

A testator has power to give mine proceeds, irrespective of whether they be corpus or income, to either the life tenant or remainderman and, of course, where he expressly states his intent, it controls. Where there is no express declaration, the courts early adopted the rule that the testator presumably intended the life tenant to get such proceeds as were current in the testator's lifetime, and, therefore, the proceeds of mines open at testator's death were granted to the life tenant. The courts have included as "open" mines, those which the testator leased in his lifetime but were not actually worked until later, and also those which the testator has specifically directed or authorized his executors to open or to lease for mining purposes, it being held that these constitute "open" mines within the testator's contemplation.

In re Ridge, 31 Chancery Division, 504, 508 (1886),

Lord Justice Lindley said:

> "As between a tenant for life and remainder-man, money paid by a lessee as the price of land won or carried away and sold by the lessee in the shape of minerals, stones or bricks, is always treated as capital and not income, unless the settlor has expressed an intention to the contrary by making the tenant for life unimpeachable for waste, or by some other expression; or unless, at the time of the settlement, the mines and minerals let were open, in which case an intention to the contrary is inferred, unless such inference is inconsistent with the language of the settlement."

Whitfield v. Belit, 2 P. W. 242.

One seized in fee conveyed the lands and all trees and mines thereon to trustees in fee to the use of A. for life with remainder over.

Held, that A. cannot open the mines or cut the trees.

Ferrand v. Wilson, 4 Hare, 388, 15 Law Journal (Ch.), 41
Held, that a tenant in tail is entitled to moneys realized by a life tenant from stone not used for repairs, and mineral from newly opened mines.

See also *Maynard's Settled Estate,* 68 Law Journal (Chancery), 609 (1899).

Howes, in The American Law Relating to Income and Principal, pages 5-6 and 7, thus states the law in this country on the subject:

> "A life tenant has no right to open new mines, quarries or wells on the land. If a trustee opens new mines, quarries or wells, the product or the rent or royalties are principal in the absence of any contrary intent on the part of the creator of the trust. He should invest such proceeds and pay the income to those entitled to the use, benefit or income of the estate" (Citing cases).
>
> "A tenant for life has the right to operate, for his own benefit, such mines, quarries or oil wells as were 'open' when he came into the estate, and he is entitled to the entire net proceeds. * * * Mines or wells are 'open' although the creator of the trust or life estate may not have been operating them himself. For example: If he had leased the land for oil purposes, stipulating for the delivery to him of a definite part of the oil produced, a bequest of the income of his estate would include these royalties. If the will or deed creating the life estate or trust shows an intention by testator or grantor that the land is to be used for mining, quarrying or oil purposes, the use and income will be taken to mean the entire net income without provision to repair waste, unless a contrary intention of the testator or grantor appears. The decisions on this point go wholly on the expressed or implied intention of the grantor or testator. *Eley's Appeal,* 103 Pa. State, 300 *McClintock v. Dana,* 106 Pa. State, 386; *In re Ridge,* 31 Chancery Divn., 504."

See also Note in 36 L. R. A. (N. S.), 1089, 1108.

It is significant that the courts, when free to exercise their own judgment, treat mine proceeds as corpus, and only give

them to the life tenant when, as *Lord Lindley* says, the testator expresses or implies such an intent.

The following cases cited in the Government brief involved "open" mines (as heretofore defined), and applied the common law rules mentioned above.

Raynolds v. Hanna, 55 Fed., 782 (Reversed on another ground, *Sub Nom. Brooks v. Raynolds,* in 59 Fed., 933).
Daly v. Beckett, 24 Beav., 114.
Hendrix v. McBeth, 61 Ind., 473.
Eley's Appeal, 103 Pa. St., 300.
McClintock v. Dana, 106 Pa. St., 386.
Shoemaker's Appeal, 106 Pa. St., 392.

In *McClintock v. Dana, supra,* the will of a testatrix left the income of the estate to an only daughter for life. The executors, under specific power given them in the will, leased certain coal mines on a royalty basis, and the daughter was held entitled to these royalties. The Court said:

> "The question here involved, as in *Eley's Appeal,* is to be determined according to the intent of the testatrix; the daughter's rights are commensurate with that intention, which, being established, the technical character of the rental becomes unimportant. * * * The authority to lease or sell the coal, which was vested, by the will, in the trustees and was exercised by them, so far as the present inquiry is concerned, places the rights of the *cestui que trust* upon the same footing as if that power had been exercised by the testatrix in her lifetime. What was done under authority of the will is to be considered as if done by the testatrix herself. If the instrument of writing here styled a lease, had been executed by Sarah H. Woodbury [testatrix] in her life time and the mines had been in operation under it at her death, her intention, as expressed in her will, could not be mistaken."

Tennessee Oil, Gas & Mineral Co. v. Brown, 131 Fed., 696,

is so palpably irrelevant and distinguishable, upon mere inspection, that it requires no comment.

There was no sugggestion in the opinion of the Circuit Court of Appeals in these cases that a mining lease constituted an absolute and immediate passing of title to the ores to the lessee, —a sale and transfer *in praesenti*. The nature of the transaction demonstrates the absurdity of any such contention. Such instruments, however, are analogous to executory contracts of sale and the rights and obligations of the parties thereunder are practically similar to rights and obligations arising and attaching under such contracts.

This is precisely recognized and enforced in the cases of,

Genet v. D. & H. Canal Co., 136 N. Y., 593, and
Browning v. Boswell, 215 Fed., 826, cited by petitioner.

To the same effect is,

Kansas Natural Gas Co. v. Board, 75 Kan., 335.

The name of "leases," commonly given to these mining contracts for convenience, is by no means conclusive as to the nature of the moneys paid thereunder. At the time of its execution it is immaterial, alike to the fee owner and the would-be miner, what their agreement may be called. Their common purpose is to enable the latter to enter upon the described premises and to extract and own the ores there existing, upon certain agreed terms. The rights, liabilities and limitations of each party are particularly set forth in the contract. It does not evidence any intention to effect a present, absolute sale of the ores and an immediate and irrevocable transfer of title thereto, but, as between the miner and the fee owner, the transaction secures to him, *at the time of the execution of the agreements*, the right (irrevocable as respects the fee owner) to secure absolute ownership of the ores, and, when he has mined and removed them in accordance with the terms of the contract, a completed sale results and the title to the ore is fixed in the miner, while the money paid for the ores becomes its purchase price in the hands of the owner. Just so are transactions under the common option contracts for the purchase and sale of land. If, and when,

the optionee elects to perform the obligations imposed upon him and to take over the land, the title to the same vests equitably in him, and when the purchase money is paid, and the proper conveyance is executed and delivered by the vendor, and placed of record, the legal title passes. If the vendor decline to carry out his contract, the vendee may maintain a suit to enforce its specific performance. The name applied to the instrument is in no wise controlling; its effect is determined by the intention of the parties expressed therein, to be effectuated in accordance with the terms of their contract.

So here we are not required to discuss what may be the proper technical designation of these mining contracts; we need only interpret them to learn the purposes of the parties, and, if those are clear, to ascertain their effect. The contracts being thus read, it is obvious that the moneys paid by the "lessee" (or vendee of the ore) are intended to be in payment for the ore, in accordance with its agreed valuation. By the removal of and payment for the ore, the property therein passes from the fee owner to the vendee. When received by the fee owner, this payment represents to him the property which he has relinquished to his vendee, and the money stands as assets in lieu of the ore which has passed. When the ore is exhausted, his principal remains in the form of the money into which it has been converted. In so far as it does not exceed the value of the ore at the time of the incidence of the tax, it is *capital;* to the extent to which it may exceed such value, it may be classed as *gross income.*

It is clear, then, that the Circuit Court of Appeals based its decision upon the correct principle when it declared in the cases at bar that the assets transferred to the land companies at the time of their organization consisted in the rights to collect the moneys payable under the outstanding contracts, regardless of whether those contracts be called options, contracts of sale or mining leases.

While we regard the discussion of this subject as unnecessary for a proper determination of the questions presented in these cases,—it being evident that the mining contracts constitute property, and create property rights often of great value—it has seemed desirable, in the light of the insistence of the petitioner, to consider the matter thus fully.

B. *The case of State v. Evans,* 99 Minn., 220.—The nature and effect of this decision are sufficiently disclosed by the comment of *Judge Sanborn* at page 150 of the record in these cases.

C. *The Evans case as a rule of property.*—But it is urged by petitioner that the decision established a rule of property binding upon this and all other Federal Courts. There is absolutely no basis for the assertion, and none of the cases cited in its support tend to sustain it. They are the following:

Bucher v. Railroad Company, 125 U. S., 555.

An action was brought in the United States Circuit Court, District of Massachusetts, to recover damages for injuries received by plaintiff while traveling on a defective highway on Sunday. A Massachusetts statute prohibited Sunday traveling, except on works of charity and necessity, and the State Supreme Court had held that one traveling on a highway for other purposes, on Sunday, could not recover damages for personal injuries. The Federal Court held that this decision, construing a law of local character, would be observed and followed and would, therefore, prevent a recovery by plaintiff, in the United States Court.

Clarke v. Clarke, 178 U. S., 186.

A will was probated in South Carolina, whose Supreme Court held that the decedent's real estate had become equitably converted into personal property at his death. Some of the real estate was located in Connecticut, whose Supreme Court

held that there had been no conversion, and a writ of error was sued out on the theory that the Connecticut Court had failed to give full faith and credit to the South Carolina decision.

Held, that Connecticut was not bound to follow the South Carolina decision, but was its own judge as to the descent of real estate within its borders.

Abraham v. Casey, 179 U. S., 210.

This court said:

> "These conclusions of the State court depended alone upon an interpretation of the local law of the State governing sales, the record of the title to real estate and the nature under the local law of the rights of the mortgagee creditor. * * * It is the duty of this court to follow the rule announced on such subjects by the highest court of the State. *Clarke v. Clarke,* 178 U. S. 186."

East Central Company v. Central Eureka Co., 204 U. S., 266.

The plaintiff prevailed in the State courts in California in a suit to quiet title. The defendant had claimed under a quit-claim deed from the plaintiff which granted part of the land under which lay the mineral deposit in dispute. The California court had held that the quit-claim deed did not purport to convey the ore under the surface.

This court said:

> "The construction and effect of the conveyance between private parties is a matter as to which we follow the court of the State."

Kuhn v. Fairmont Coal Co., 215 U. S., 349.

The Supreme Court of West Virginia held, in another action, that a lessee of coal lands was under no implied duty to leave in place sufficient coal to support the surface.

The *Kuhn case* was instituted in Federal court shortly before this decision (which was the first of its kind), was rendered and the question was certified to this court, whether

the Federal court was bound by the *subsequent State decision.* This question was answered in the negative.

Foster v. Elk Ford Oil & Gas Co., 90 Fed., 178.

It was held that the Federal court in this case would follow state decisions of West Virginia, establishing rules affecting real property in the State.

York v. Washburn, 129 Fed., 564.

In Minnesota oral leases for more than one year are within the statute of frauds, and the Minnesota decisions construing the statute were followed to the effect that an oral contract for a lease of land in that State, though unenforcible, is not void —hence that the lessee cannot recover earnest money paid thereon,—the lessor being able and willing to perform.

Fretts v. Shriber, 181 Fed., 279.

Held, that a decision by the State court that an instrument is an option and not a contract of sale, while not binding on the Federal court when rendered subsequent to the time the instant case arose, will, nevertheless, be followed when the Federal court is in doubt.

All the above cases concerned private disputes in most instances governed by local laws or rules of property, and in none of them was the construction of a Federal statute involved. They have no application here.

The cases at bar not only involve an interpretation of a Federal law, but the law in question is a taxing law which under the Constitution must operate with uniformity to be valid. Yet it is urged that the excise tax which it seeks to impose shall be collectible in Minnesota by reason of a decision rendered by the State court in an action having no connection whatever with the Federal Act or with the subject of taxation, while, by the same reasoning, the tax could not be imposed in Illinois, or

Iowa, or West Virginia or Pennsylvania.

No argument beyond the statement of the contention is required for its refutation.

It is obviously essential that the Federal courts shall exercise an independent judgment in construing a Federal statute, uninfluenced by the views of any State court, to the end that the statute may be uniform in its application.

The rule may be generally stated as follows:

In reference to the doctrines of commercial law and general jurisprudence, the interpretation of the common law, and the construction and application of the Federal Constitution and Federal statutes, and the determination of matters of Federal concern, the United States courts will exercise independent judgment, although they will regard with the hightest respect decisions of the State courts on these subjects and, where the question seems to be balanced with doubt, will lean toward an agreement of views with the State courts; but where the construction of State Constitutions or statutes is concerned, in matters of local law and procedure, and in cases involving local rules of property and of contract, or of State public policy, the Federal courts will be governed by the law of a State as expressed in its Constitution or statutes, or declared by its highest court.

Swift v. Tyson, 16 Peters, 1.
Olcott v. Fond Du Lac Co., 16 Wall., 678.
Hough v. Texas & Pacific Ry. Co., 100 U. S., 213.
Burgess v. Seligman, 107 U. S., 20.
Clark v. Bever, 139 U. S., 96.
Hartford Fire Ins. Co. v. C. M. & St. P. R. R. Co., 175 U. S., 91.
Calhoun Gold Mining Co. v. Ajax Gold Mining Co., 182 U. S., 499.

In *Olcott v. Supervisors, supra*, a case involving the validity of county obligations issued for the construction of a railway in Wisconsin, *Mr Justice Strong* said:

"It is undoubtedly true in general that this court often follows the decisions of the highest courts of the States respecting local questions peculiar to themselves, or respecting the construction of their own constitutions and laws. But it must be kept in mind that it is only decisions upon local questions, those which are peculiar to the several States, or adjudications upon the meaning of the constitution or statutes of a State, which the Federal courts adopt as rules for their own judgments. * * * Now, whether a use is public or private is not a question of constitutional construction. It is a question of general law. It has as much reference to the constitution of any other State as it has to the State of Wisconsin. Its solution must be sought not in the decisions of any single State tribunal, but in general principles common to all courts. The nature of taxation, what uses are public and what are private, and the extent of unrestricted legislative power, are matters which, like questions of commercial law, no State court can conclusively determine for us."

The case of *Hartford Fire Insurance Co. v. C., M. & St. P. Ry. Co., supra,* brought up the question of the public policy of the State of Iowa. *Mr. Justice Gray,* delivering the opinion of this court, referred to the fact that it was settled doctrine that a provision in a contract between a railroad corporation and the owner of goods received by it as a common carrier that it was not to be liable to him for loss or injury caused by the negligence of itself or its servants, is contrary to public policy. He added that such a provision "must be held to be void in the "courts of the United States, without regard to the decisions "of the courts of the State in which the question arises. But "the reasons on which those decisions are founded are, that "such a question is one of general mercantile law; that the lia- "bility of a common carrier is created by the common law, "and not by contract"; and that, therefore, the Federal courts must be free to pass upon such matters uninfluenced by decisions of local tribunals. He then added (page 100):

"Questions of public policy as affecting the liability for acts done, or upon contracts made and to be performed, within one of the States of the Union,—when not control-

> led by the Constitution, laws or treaties of the United States, or by the principles of the commercial or mercantile law, or of general jurisprudence of national or universal application—are governed by the law of the state as expressed in its own Constitution and statutes, or declared by its highest court."

Calhoun Company v. Ajax Company, supra, was a controversy between owners of intersecting ore veins in the State of Colorado, whose rights depended upon the construction of the Federal mining statutes.

The plaintiff in error claimed that the Colorado Supreme Court had given the statute a construction favorable to him, which became a rule of property prior to the location of his vein, and that the present reversal of the rule would take away what he regarded as a vested right.

This Court said:

> "There are serious objections to accepting that consequence as determinative of our judgment. We might, by doing so, confirm titles in Colorado, but we might disturb them elsewhere. The statute construed is a Federal one, being a law, not only for Colorado, but for all of the mining States, and, therefore, a rule for all, not a rule for one, must be declared. * * * It may be that the repose of titles in the State was best effected by a reversal of the prior cases. At any rate, a Federal statute has more than a local application, and, until construed by this court, cannot be said to have an established meaning. The necessity of this is illustrated, if it needs illustration, from the different view taken of sections 2322 and 2336 in California, Arizona and Montana from that taken in the prior Colorado cases. * * * Manifestly on account of this difference, if for no other, this court must interpret the sections independently of local considerations."

No decision of the Supreme Court of Minnesota, or of any other State, can, consequently, control the interpretation to be placed by this court upon a tax law which must operate uniformly in every part of the United States.

We will now turn to the important question under this division of the case, and inquire

What Composes Gross Income?

In the decision announced by *Judge Willard* in the District Court, the meaning of the words *gross income*, as employed in the Act of August 5th, 1909, was carefully considered. He regarded the most important question in the case to be whether or not the sums of money which were received by the companies, during the years for which they were taxed, were gross income within the meaning of the act (page 118).

At page 119 we find this statement:

> "I do not base my decision upon the meaning of that word [depreciation] nor upon its use in the act, but rather upon the meaning which should be given to the words *gross income*. Those are the words used in the act, together with the words 'net income' and 'earnings.' The words 'gross receipts' were not used in this act, as they are in the case of *Spreckles Sugar Refining Co. v. McLain*, 192 U. S. 397, nor are the words used here 'deposits,' as was the word used in *Society for Savings v. Coite*, 6 Wall. 594. What was intended by the use of the words gross income? What does the word income mean? In ordinary speech people recognize the difference between capital and income. I believe that the ordinary meaning attached to income, when it is not derived from personal exertion, is that it is something produced by capital without impairing that capital and which leaves the property intact, and that nothing can be called income for the purpose of this act which takes away from the property itself. If it does, then it ceases to be income, and amounts to a sale of capital assets. * * * It necessarily follows from the views which I have expressed, that the words 'gross income' do not mean 'gross receipts.' It is apparent to me that gross income cannot mean gross receipts. * * * *It is perfectly apparent from the language of the act, that it was never the intention of Congress to impose a tax upon a corporation that was not making money; it was never its intention to tax a losing business*" (page 120).

The sentence last quoted presents an unanswerable argument against the contention of the petitioner here, that *gross receipts* and *gross income* mean the same thing under the Act of 1909. It cannot be assumed that the petitioner will insist that the Act of 1909 contemplated the imposition of an excise tax upon a corporation doing a losing business. The only rational interpretation of the law is that, unless a corporation organized for profit and engaged in business shall produce net profits in excess of $5,000.00 per year, it shall not be subject to the tax.

Flint v. Stone-Tracy Co., 220 U. S., 145.

It is, of course, perfectly clear that an owner of land, valuable only for its mineral content, and embraced in a mining contract which he has made authorizing his grantee or lessee to mine and remove all of the ore in consideration of the payment of a stated amount per ton, has, if the grantee or lessee retain and perform the contract until the exhaustion of the ore deposit, *no property right of value in the land except the right to demand and receive such royalties;* and when the ore is exhausted the value of his estate in the land is also exhausted.

If such owner desire, through pressure of necessity or otherwise, to realize, before the exhaustion of the ore, a present lump sum for such estate, he may do so by a conveyance of the title to the land, subject to the outstanding contracts, to any purchaser he may procure.

Now is it conceivable that, in such a case (and instances of such sales of leased property are not unknown), the seller will be required to pay a tax upon the entire amount received by him, upon the theory that such moneys constitute income? And is it conceivable that the royalty payments made to the purchaser from year to year, under the contracts, are not in law, as they are in fact only a conversion into money of the investment which he has made in the land, and is, therefore, a

mere return to him of his capital?

If we are right in this, then the receipts of the respondent companies do not constitute gross income, but are simply a conversion and return of invested capital.

Judge Willard further said:

> "That this ore in place is capital, and is part of the real estate, I think admits of no question. It is just as much a part of the real estate as trees standing on the land. Let us suppose that John S. Pillsbury & Co., when it owned this land with the timber still standing thereon, was a corporation; that in 1908 it sold the timber with the privilege of removing it within ten years, and that in 1909, 1910 and 1911 the purchaser cut the timber and during these years paid the purchase price of it. Could it be said that the purchase price so received was income within the meaning of this Act? I do not think that it could. It was not income, it was the property itself, and, as I said before, the trees standing on the land were no more part of the realty than is the ore under the surface of the land. They are both capital, and money derived from the sale thereof cannot be considered income, whether it be money received from ore, or money received from the timber (page 121)."

And again:

> "This case is to be decided upon what the actual facts are, and not upon what they appear to be. The actual facts are that nobody has made a dollar out of these properties by these incorporations. The evidence shows that the same persons own the stock who owned the property before the corporations were organized. The mere change of form of ownership from that of these individuals to that of a corporation owned by the same individuals, cannot produce such large profits as are claimed here. The only conclusion that I can come to on this branch of the case is, that this money was never received as gross income, and cannot be in any sense called income; that it was never taxable and that the tax on it was unlawfully collected" (pages 123-4).

In the opinion filed in these cases by the Circuit Court of Appeals, the distinction between income and proceeds of the conversion of invested capital is shown with equal clearness and logical conviction. Thus at page 147:

> "That the word *income* in this Act is not synonymous with the word *receipts*, and that it does not include receipts from the conversion without gain or profit of any part of the property of the corporation into money, or into any other form, is demonstrated by the fact that this word income appears in the clause 'the gross amount of the income of such corporation' and segregates and designates a specific part and not all of the receipts of a corporation as the basis of the measure of the tax; by the fact that only those expenses paid out of income, none of those paid out of capital or property, are to be deducted; by the fact that a deduction for depreciation of property is to be made; by the evident purpose and the whole tenor of the Act. *This word 'income' is used throughout the statute in contra-distinction to property or invested capital, and it was neither the intention of the Congress, nor is it the legal effect of the Act, to impose any tax on account of the amounts received by a corporation that is not engaged in the business of buying, selling or trading in property, from the conversion of its property without gain into money or into any other form.* These corporations were never engaged in any such business. And it is not doubtful that the small amounts of money received by them from the sales of the lots and lands that were conveyed to them at their organization in 1907 were not income, but were mere proceeds of parts of their property on account of which they could not lawfully be taxed."

Can the accuracy of the statement above quoted be denied, that, in the Act of 1909, "this word income is used throughout the statute in contra-distinction to property or invested capital"? Nevertheless, *the whole contention of the Government in these cases rests upon a denial of that statement.* The tax imposed by the Commissioner was computed upon the theory that *the entire gross receipts of the respondents in each year constituted gross income*, and that the amount thereof, after deducting merely taxes and expenses paid in each year, respectively, was the net income by which the excise tax should be measured. That this position of the Commissioner was deemed accurate by the United States Attorney who tried the cases below is evidenced by the requests for declarations of law submitted by him as follows:

I.

"That the royalties paid to and received by the plaintiffs under and pursuant to the several mining leases referred to in the evidence, constitute and are gross income within the spirit and meaning of the corporation tax law approved August 5th, 1909.

II.

"That the Commissioner of Internal Revenue was authorized by said Act of Congress to assess against the plaintiffs the taxes mentioned in the complaints herein upon the royalties paid to the plaintiffs for the years 1909, 1910 and 1911.

III.

"That the defendant is entitled to judgment for the taxes collected under and pursuant to the assessment made by the Commissioner of Internal Revenue, being the same taxes to recover which these actions were instituted" (page 113).

Manifestly, if the attitude of the Commissioner and of the United States Attorney is correct and the respondents were taxable under the Act of 1909 upon their entire gross receipts, which, as demonstrated in the opinion of the Circuit Court of Appeals, embraced the entire value of the properties conveyed to the respondents, there is *no* distinction to be made under the Act of 1909 between "income" and "property or invested capital."

We quote further from the opinion of the Circuit Court of Appeals:

"But were the royalties which had been owing to these corporations by the lessees since 1906 and which these corporations collected and received in 1909, 1910 and 1911, as they fell due, income by the amount of which the taxes upon them must be measured under the tax act, or were they the mere proceeds of the conversion without gain or profit of parts of their property into money, and no part of the

measure of their lawful tax? The lands, and hence the property, of the corporations had no substantial value without the rights to collect the royalties the lessees had covenanted to pay. The leases had been made by the former owners prior to 1907 and, if there was any gain, profit or income from the making of the leases, that income accrued years before the tax act took effect, and the corporations are exempt from any taxation on account of it. * * * In 1906 and 1907 these corporations took from the lessors the latter's claims and rights to collect and receive from the lessees the royalties they had covenanted to pay for the ore, and the title to the lands, and issued their stock therefor. If there was any gain, profit or income in this transaction, it was made in 1906 and 1907, at least two years before January 1st, 1909, when the tax took effect, and the corporations are exempt from taxation on account of the income" (pages 147-148).

"If the purchase price of the ores, called royalties in the lease, ever became income, *it must have been when the leases were made.* But the truth is that the leases merely changed the form of the property of the lessors from ores to the rights and claims to the purchase price of the ores which the lessees covenanted to pay under the name of royalties, and the receipts by the corporations of the payments of parts of those claims which fell due in 1909, 1910 and 1911, were but another substitution of the cash received for the parts of the claims paid" (page 150).

At page 151, adverting to the circumstances leading up to the incorporation of the respondents, and their particular purpose of providing a practicable mode of partition of the undivided interests of the stockholders, the opinion of the Circuit Court of Appeals continues:

"Any one of these owners had the equitable right to such a partition. If one or more of them had petitioned the proper Court for such relief and the Court had appointed a receiver or master to collect the claims for the purchase price of the ore, or royalties, and to convert the property into money and distribute it among the owners according to their respective interests, could any Court lawfully have held that the proceeds thus obtained were the gain, profit or income of the equitable owners? These corporations stood in the same relation to the claims for the purchase price of the ore, or the royalties and the moneys they collected from them, and to the equitable owners of the prop-

erty, their stockholders, that such a receiver would have stood. In reality they received and held these claims and the moneys collected from them in trust to distribute them among the equitable owners of the property, and the moneys they have collected were no more the income of the corporations or of their stockholders than is any part of the claims that are not collected from any other part of their property. Those collections were simply another form of the property of the corporations, and of the stockholders, substituted for the parts of the claims paid. The considerations which have now been stated have convinced that there was no error in the decision of the Court below that the moneys collected by the corporations in 1909, 1910 and 1911, under the mining leases, on the claims for the royalties on, or the purchase price of, the ore, were not either gross or net income within the meaning of the tax act; and that corporations that were, when the corporation tax act took effect on January 1st, 1909, the owners of claims purchased years earlier for royalties on ores under mining leases made by their grantors,—whereby the absolute right to dig and have all the ore in the lands leased, which without the ore were worthless, and to remove it at any time during terms so long as to be equivalent to an unlimited time, was granted to the lessees, and they covenanted to pay therefor yearly fixed amounts per ton for the ore extracted and minimum amounts yearly to be credited on ore subsequently removed, in case sufficient to come to the minimum was not extracted in any year,—are not taxable on account of the amounts coming due and received by the corporations in partial payment of those claims during the years 1909, 1910 and 1911, where their property was formerly owned and was conveyed to them by their original stockholders, and the sole purpose of the conveyance and of their organization was to enable them to collect these claims, to convert the property conveyed to them into money, and to divide the proceeds among their stockholders."

The manner of conversion and partition of the various properties owned by the Pillsbury heirs and Messrs. Longyear and Bennett necessarily depended upon the respective natures thereof. It is not denied that properties which have no value except for the iron deposits thereon, must be disposed of in the one usual and accepted manner in which iron ore is sold, to-wit: by so-called "mining leases" (pages 95-6; Decision of

Circuit Court of Appeals, pages 144-5). Properties which may be non-mineral and have value for agricultural purposes are properly disposed of by sales in tracts of such areas as the demands of the locality will permit. Properties which are saleable in the form of village lots are justifiably disposed of in that form. By the vesting of all the undivided interests in one corporation it was enabled to handle them in these ways.

During the entire time comprehended in the controversy here presented, all proceeds received by the respondents out of the conversion of their properties in any manner were immediately distributed to their stockholders, and no portion was at any time retained for the speculative purchase of other properties, or for investment for the common profit and benefit of the corporate members. The capital of each corporation has always been represented only by the property conveyed to it at the time of its organization; it was not capable of producing gain by natural increase or more profitable disposition, and it has not been added to or turned over by purchases and sales, or in any form of business transaction, either with a view to profit or otherwise, but, on the contrary, has been steadily diminished and distributed as opportunity to liquidate and partition the assets has presented.

As observed by *Judge Willard*, the Act carefully employs the word "income," with reference to both gross income and net income, and not the word "receipts."

By the use of the term "gross amount of the income," it is apparent that Congress could not have meant "gross receipts." Had it intended so unusual and important a scheme as to tax *gross receipts*, it would have used language appropriate to that end. The distinction between *gross income* and *gross receipts* is so well understood that it must be accepted that, if Congress had meant the latter, it would have said so, just as it said it in the Act of June 13, 1898, which imposed a tax based upon "the

gross annual *receipts* of any corporation or company carrying on or doing the business of refining sugar." In that instance Congress designed to tax gross receipts, and it said gross receipts. (See *Spreckles Sugar Co. v. McClain*, 192 U. S., 397). It must be presumed that Congress employed the words "gross income" in their commonly-understood meaning, which, beyond question, excludes the proceeds of converted capital, and differentiates them from "gross receipts."

In the ordinary significance of the term "income" it means profits, earnings, gains or increase, and not receipts.

Thus one derives income from payment of interest upon a bond, but, when a bond matures and is paid off with the last interest payment, the *principal* received is never considered as income, although it is distinctly an item of cash receipts, and would so be entered on the owner's books.

The same is true of a mortgage debt, the interest accruing thereon alone being considered as income.

If real or personal property be sold under a contract permitting payment of the purchase price in instalments extending over a period of time, with provisions for annual or semi-annual interest on deferred payments, such interest only is entered to the account of income. The various instalments of principal as paid are never so regarded, but are placed to the account of capital investment, and are not chargeable with income tax.

Foley v. Fletcher, 3 H. & N., 769.

The royalty payments received by the respondents were simply such instalments of purchase price of the ores taken under the mining contracts.

Various Definitions of "Income".

While the whole scheme of the Act of 1909, as its text so clearly indicates, makes a pronounced distinction between *income* and *capital* and, with meticulous care, excludes the latter from the measure of the excise tax, we append a few definitions of "income" as cumulative evidence of the purpose of the legislation.

In *Black on Income Tax*, section 32, we find this definition:

> "'Income' is defined as that gain which proceeds from labor, business, property or capital of any kind, as the produce of a farm, the rent of houses, the proceeds of professional business, the profits of commerce or of occupation, or the interest of money or stock in funds, etc.; revenue, salary, especially the annual receipts of a private person or a corporation from property. It means that which comes into or is received from any business or investment of capital without reference to the outgoing expenditures. * * * But, on the other hand, in a statute imposing taxes, 'income' means gross receipts, not net profits, *unless it is so specified. Whenever the law means to tax the clear profits arising from the employment of capital or otherwise, the expression used is 'net income' or 'net annual income'* * * *
>
> *We conclude, therefore, that for the purpose of an income tax a proper definition of the word 'income' would be, all that a man receives in cash during the year, except such sums as are merely capital or principal in a changed form; that is, excluding sums which are merely the proceeds of some other form of capital converted into cash.*"

In section 34, *Mr. Black* continues:

> "Both in popular and legal parlance 'income' is distinguished from 'capital' or 'principal.' Capital is the source of income. Income is the fruit of capital. Capital may be made very mobile and constantly change from one form of investment to another. Each time that it returns to the owner, it may or may not bring income with it, but it would be a misnomer to reckon the whole of such return as 'income' simply because it is so much money coming into the possession of the owner. *Out of the fund so returning there must first be deducted, in case there has been no loss, a*

sum sufficient to replace the capital originally invested, and the balance, if any, will be income. Thus when money is loaned on a promissory note for one year at interest, and the note is paid at maturity, with the accumulated interest, the sum received must be proportioned between capital and interest. The receipt of so much of that sum as equals the face of the note is not a receipt of income; it is a replacement or substitution of capital; only the money received as interest constitutes income. * * * Again, a sum of money received from a railroad company in payment of damages for a part of a person's land taken by the railroad for its use is not income; it is a substituted capital."

Mr. Seligman, in his treatise entitled "The Income Tax," says:

"Section 5: The meaning of income. At the outset of such a study it is desirable to secure a clear idea of what is meant by income. Income is, of course, to be distinguished from mere receipts or gross revenue. * * * By income is always meant net income as opposed to gross income. In other words, from the receipts of any enterprise we must, in the first place, deduct the expenses of the enterprise—that is, the outlay incurred in securing the gross product. * * * Income, therefore, always means net income. * * * What has been stated is equivalent to saying that income is that which comes to an individual above all necessary expenses of acquisition, and which is available for his own consumption. Since the income is a flow of wealth it must always be estimated for a definite period, so that, when we speak of income for the purposes of taxation, we really mean annual income. Strictly speaking, income as contrasted with capital denotes the amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, *so that in consuming it his capital remains unimpaired.*"

The Supreme Court of Georgia, in *Mundy v. Van Hoose,* 104 Ga., 625, emphasizes the distinction between capital and income, saying:

"Income, as defined by Mr. Webster, is that gain which proceeds from labor, business, property, or capital of any kind—as the produce of a farm, the rent of houses, the proceeds of professional business, the profits of commerce or occupation, or the interest of money or stock in funds, etc. *The definition demonstrates the distinction between capital*

assets and the income which they produce; the latter is the profits, product or gain derived from the use or investment of the former."

In *Spooner v. Phillips*, 62 Conn. 262, the court said:

> "The word income has a broader meaning [than dividends], *but hardly broad enough to include things not separated in some way from the principal.* It is not synonomous with 'increase.' The value of stock may be increased by good management, prospects of business, and the like, but such increase is not income. It may also be increased by an accumulation of surplus; but so long as that surplus is retained by the corporation either as surplus or increased stock, it can in no proper sense be called 'income.'"

In *Stratton's Independence, Ltd., v. Howbert*, 231 U. S., at page 415, *Mr. Justice Pitney* says:

> "For 'income' may be defined as gain derived from capital or labor, or from both combined."

This definition was approved in

> *Connecticut General Life Ins. Co. v. Eaton*, 218 Fed., 188, 205.

In *Wilcox v. County Commissioners*, 103 Mass., 544, under a statute of Massachusetts imposing a tax upon "income from profession, trade or employment exceeding $1,000," income was defined as follows:

> "The income from a 'profession, trade or employment,' which is taxable under our system of laws, *is an entirely different thing from the capital invested in the business or the stock of goods, in the purchase of which the whole or any part of such capital may have been expended.* The income meant by the statute is the income for the year, and is the result of the year's business. It is the net result of many combined influences; the use of the capital invested; the personal labor and services of the members of the firm; the skill and ability with which they lay in, or from time to time renew, their stock; the carefulness and good judgment with which they sell and give credit; and the foresight and address with which they hold themselves prepared for the fluctuations and contingencies affecting the

> general commerce and business of the country. To express it in a more summary and comprehensive form, it [income] is the *creation* of capital, industry and skill."

If income is not skill, or industry, or *capital;* if it is something created by and out of capital, and is in its essence an entirely different thing from capital invested, it is something that is acquired and possessed *in addition to* the capital.

In the opinion filed by *Judge Sessions* in *Mitchell Bros. Co. v. Doyle,* 225 Fed., 437, it is said:

> "*In each instance income is and must be something over and above the original capital investment plus the cost of production and sale.* This rule has been uniformly recognized by the Commissioner of Internal Revenue in the decisions and directions issued from his office for the guidance of the collectors of corporate excise taxes and of the taxpayers themselves."

In the same case, an appeal, not yet reported, *Judge Denison* said:

> "*It is clear that by the term 'income' Congress did not intend to include the proceeds of capital assets sold or converted during the year; nor can it be material whether such proceeds are re-invested in other property or remain in the treasury of the company, or are distributed to the stockholders;* nor whether, in case of such distribution, they are called dividends or capital. The controlling question must be whether assets so converted are, in fact, *at the beginning of the tax period,* properly to be classed as capital assets. If they are of that character they cannot be 'income' received during the later period; they represent merely capital in the changed form. * * * Indeed, no one disputes the proposition, in its broadest aspect, that the selling price of capital assets is not 'income.' "

From "*The American Law Relating to Income and Principal,*" by Edwin A. Howes, Jr., we take the following excerpts:

> "Income of property consists of the proceeds of what the property *produces,* the profit which comes from its use in business, or what is paid for its use by another than its owner. Principal, or capital, is the property itself" (page 1).

"The owner of a mine is likely to consider the product of the mine as income. It is not real income, but is part of the property itself. Although timber is a real product of the land, the production of it covers so long a period that a life tenant, or a trustee for a life beneficiary, cannot ordinarily treat it as income, because the taking of it strips the land of something which cannot be replaced while the life interest lasts" (page 2).

"The products of mines, quarries or oil wells are really not products, but part of the land itself, which once used cannot be replaced. Such products, therefore, do not come within the strict, narrow meaning of the word income" (page 5).

If one of the stockholders of the respondent corporations had died in January, 1909, how would his estate have been valued for the purposes of inheritance taxation? Would a contention that the proportionate part of the corporation assets (consisting almost wholly of the moneys payable under the mining contracts) represented by his stock was of no capital value, because all of the royalties receivable thereunder would be income and not principal, be acquiesced in by the taxing officials or be sustained by the Courts? Would not rather, the value of the stock, as computed from a valuation of the payments receivable under the mining contracts, be the first and controlling inquiry?

If an individual owned, on January 1, 1909, a tenth of the capital stock of the respondent corporations, and nothing else, would he be said to have no invested capital? And if his stock represented invested capital, when that capital was returned to him in the form of royalty payments, would it not, as being capital, be free from income taxation?

Proceeds of Sales of Capital Assets are Not Income.

As respects pecuniary returns from investments in any kind of property, it may therefore, be accurately asserted that *income is that part of the net receipts of a tax payer which repre-*

sents gains or profits after returning to him the full value of his principal investment, from the use, disposition or transmutation of which the gain or profit results.

The case of *Stevens v. Hudson's Bay Company,* 101 L. T. Rep., 96 (reported also in 5 Tax Cases, 424), is an interesting and instructive illustration of the approval and application of this principle.

The company kept accounts of land sales separate from the accounts of its trading department. Such accounts showed that in 1903, in addition to profits from trading, the company received £177,000 from land sales. The surveyor of taxes insisted that the company was liable to taxation on this sum as being profits or gains in trade. The company claimed that the moneys were not taxable; that they represented part of the capital value of land acquired by the company under its original charter of 1670, being reserved to the company under an act of 1868, whereby, in consideration of £300,000 paid in money, and the right to select from time to time one-twentieth of the fertile lands resigned by it, there were surrendered to the Dominion of Canada the lands held under the original charter, and the privileges and rights of the "Governor and Company of Adventurers of England trading into Hudson Bay." Under this arrangement, the company had selected lands at different times, and had sold portions thereof to persons willing to buy, and the sums in question represented the net amount derived from such sales during the year 1903. These moneys, and others, were applied in reducing the capital of the company by £2 per share.

Channell, J., decided that the money was taxable as income and the company appealed. The decision was reversed.

The *Master of the Rolls*, after reciting the above facts said (at page 97):

> "I need not stay to observe that, if the money is otherwise liable to income tax, it cannot escape taxation by rea-

son of its being applied to a capital purpose.

"The real question is whether this money can be regarded as profits or gains derived by the company from carrying on a trade or business. In my opinion it cannot. The company was doing no more than an ordinary land owner does who is minded to sell from time to time, as purchasers offer, portions, suitable for building, of an estate which has devolved upon him from his ancestors. I am unable to attach any weight to the circumstance that large sales were made every year. This is not a case where land is, from time to time, purchased with a view of re-sale; the company are only getting rid by sale as fast as they reasonably can of land which they acquired as part of a consideration for the surrender of their charter. Channell, J., has treated it as a conclusion of law from the facts stated in the case, that the company were carrying on the trade of selling land. With great respect to the learned judge, I am unable to accept this view."

The statement of the Master of the Rolls is eminently true of the owners of iron properties who do not carry on mining operations, but who are only getting rid of their ore as fast as they reasonably can by selling it under so-called mining leases for a fixed royalty price.

In the same case, *Farwell, L. J., said* (pages 97-8):

"*It is well settled that income, not capital, is taxable under the income tax acts.* * * * Income is not the less income for the purposes of income tax because it is produced by embarking capital in a wasting subject matter—e. g., in buying and working mines; *nor, on the other hand, does an annual sum become income merely because it is paid annually. If it be in its inception, and not by adjustment and subsequent recoupment, composed partly of capital and partly of income, then the tax is chargeable only on so much as is income.** * * The actual claim by the Crown in the present case is extravagant, for it is for the whole of the purchase money. If the company were to be treated as trading, they must at least be allowed the price paid for the land—namely, a proportionate part of the value of the area conveyed by them to the Canadian Government, less 300,000£. paid."

Another instructive case is found in

Secretary of State for India v. Scoble, 89 L. T. Rep., 1.

Under a contract made with a railway company, the Indian Government had power to purchase its railway, and it was agreed that the purchase money might, upon notice, be paid in the form of an "annuity" for a term of years. The purchase was afterward made by the government, which elected to pay the price in half-yearly instalments for forty-nine years. The Secretary of State for India deducted an income tax on the full amount of the first two payments, and Scoble and others sued to recover the sums so withheld.

It was decided that the payments were not annuities or annual payments within the meaning of the acts imposing a tax "for and in respect of all profits arising from interest, annuities, dividends, and shares of annuities payable out of any public revenue."

Lord Halsbury, giving judgment, said (at page 3):

> "*Was it the intention of the income tax acts ever to tax capital as if it was income? I think it cannot be done, both upon the language of the Act itself, and upon the whole import and meaning of the income tax acts, and that it never was intended to tax capital, at all events as income.* * * * And I cannot disagree with what all the three learned judges of the Court of Appeals pointed out, that you start upon the inquiry into the matter with the fact of *an antecedent debt which has got to be paid; and if these sums, which it cannot be denied are partly in liquidation of that debt which is due, are to be taxed as if they were income in each year in which the payment is being exacted, the result is that you are taxing part of the capital.*"

A more exact definition of the situation in the present cases cannot be conceived. The moneys received by the respondent companies under the respective mining contracts were part of "an antecedent debt which has got to be paid;" and those sums which, as in the English case, it cannot be denied were paid in liquidation of that debt as it became due, were a part of the

capital of the corporations. An excise tax laid with reference thereto, is one based upon capital and not upon income.

In *Baldwin Locomotive Works v. McCoach*, 215 Fed., 967, 969, the following interesting analysis of the Act of 1909 was made by Judge Dickinson, whose decision allowing a recovery of an excise tax unlawfully exacted from the plaintiff was affirmed by the Circuit Court of Appeals for the Third Circuit, in 229 Fed., 59:

> "The first observation called forth by the act of Congress is that Congress has declared its will upon three points: First, that the amount of the tax shall be based upon the 'net income' received by the taxpayer within the year. Secondly, that this 'net income' shall be determined by finding first the 'gross income' and then taking from this amount certain specified deductions. Thirdly, no deductions, with one exception, shall be made unless the amounts to be deducted were *paid out of income* within the year, and no income is to be considered unless it was income *received within the year*. The general purpose is, first, to have the amount of the 'net income' received during the year determine the amount of the tax.
>
> The second observation to be made is, the choice of terms which Congress has made. The amount of the tax might have been made to turn upon the 'net gains, profits, increase and income,' or upon the amount or value of the 'net assets' of the taxpayer, or upon the 'increase in the net assets.' Congress has seen fit to confine itself to the 'net income' alone. * * * A like choice of words is to be discovered in the part of the Act which enumerates what shall be deducted from the 'gross income.' The 'ordinary and necessary' expenses, the 'losses,' the 'taxes,' etc., are all to be determined by what the corporation has actually *'paid.'* It is not 'expenses and losses' which have been properly 'incurred,' or taxes which have been lawfully 'assessed,' but the amount which has been 'paid' is made the criterion. The deduction of a reasonable allowance for 'depreciation,' which is permitted also to be made from the amount of gross income, is not out of harmony with this general test of 'payment.' It is the case of the exception proving the rule, because this allowance, not being for actual payment, would not be justified were it not expressly mentioned."

From the foregoing, two principles are made clear: One, that the income which is made the measure of the tax is *annual net income received between specific dates twelve months apart;* the other, that income or other property received before the beginning of any such period is not taxable therein. Applying those principles to the present case, it will be found that

The Properties Owned by the Respondent Corporations on January 1, 1909, were Capital at that Date.

The incidence of the corporation excise tax was fixed by the Act as of January 1, 1909. Therefore, the calculation must date as from that time.

It is wholly immaterial whether a corporation received an income, large or small, made profits or incurred losses, in any year or years before 1909; the only important inquiry as to 1909, or any year thereafter, is, *What was the gross income for that year?*

Income received before that date neither required nor permitted the imposition of an excise tax for 1909 any more than income received after December 31st, 1909.

Bailey v. New York Cent. R. R. Co., 106 U. S., 109.
Lynch v. Turrish (decided Sept. 4, 1916, C. C. A., 8th Circuit), not yet reported.

Undoubtedly, the value of the corporate assets of the respondents was exactly the same on December 31st, 1909, as it was on January 2nd, 1907, when the last of the mining contracts was made, except as it had been reduced by payments meanwhile made under the contracts. The right to collect for every ton of ore on the lands of the companies was limited to the stipulated price named in the contracts, and admitted of no increase by way of advance in valuation. *If, then, the value of the corporate assets was unchangeably established before January 1, 1909, so that the corporation could neither gain*

nor lose a dollar on account of them in any subsequent year, and all its transactions consisted only in receiving for its stockholders, in any tax year, the value so fixed of the assets transmuted into cash in such year, it is manifest that there could result no gross income. If the corporation retained in its treasury all its cash receipts, it would be no richer than it was on January 1, 1909; but it would be poorer by the sum of its taxes and expenses paid out of such annual receipts.

To this effect was the decision filed in the United States District Court for the Western District of Michigan in the case of

Mitchell Bros. Co. v. Doyle, 225 Fed., 437.

It appeared that in 1903 a lumber company acquired certain timber properties which were thereafter carried upon the books of the company at the cost price; but by December 31, 1908, the properties had increased in value at the rate of $20.00 per acre. In its excise tax returns for the years 1909 to 1912, the company deducted from the gross receipts for timber converted into lumber and for cut-over lands which were sold by it—as being a return or conversion of capital assets—amounts which were admittedly the fair market value of such timber and land on the first day of January, 1909. The Commissioner of Internal Revenue declined to accept such return and allowed, as a deduction from the gross receipts for each year only the original cost in 1903 of the timber and lands sold, and assessed against the corporation an additional excise tax upon the difference between the cost in 1903 and the admitted value on January 1, 1909, upon the theory that any difference in value above the cost was *income for the year in which the property was sold.* The additional taxes thus assessed were paid under protest and suit was brought to recover them, judgment being entered in favor of the corporation for the sum claimed.

Touching the question under discussion, *District Judge Sessions* observed, at page 439:

"The plaintiff claims that its standing timber and other property were capital assets, and that the portion of the proceeds derived from the cutting, manufacture, and sale of such timber, measured by the actual stumpage value thereof, did not constitute income, and therefore that, in computing its taxable net income, it was entitled to deduct such actual stumpage value of its timber from its gross receipts. The Commissioner of Internal Revenue concedes the right of the plaintiff to deduct the original cost price of the timber, as shown by its books, from its gross receipts, but denies its right to make any deduction on account of increase in values. The Attorney General contends that *all* the proceeds derived from the manufacture and sale of the timber constituted income, and that plaintiff, in its return of taxable net income, had no right to make any deductions whatsoever, on account of either cost price or actual value of the timber stumpage.

"The proofs in this case show conclusively that, between the time of their purchase in 1903 and the 1st day of January, 1909, when the Excise Tax Law became effective, plaintiff's timber, lands, and other property had so increased in value that they were fully worth the amounts which were deducted from gross receipts as capital assets. It cannot be denied that the plaintiff's standing timber was a part of its capital assets, and that the conversion of the timber into lumber and the sale of the lumber constituted at least an indirect sale of the timber, and so of capital assets. The mere change of the timber into lumber or money did not transform capital into income. The miller who grinds his stock of wheat into flour and sells the flour does not thereby destroy or impair his capital and convert it into income. The same is true of the manufacturer who converts his cotton into cloth, the landowner who sells his lands for cash, the furniture maker who transforms lumber and other material into chairs and tables, the ironmaker who produces steel rails from iron ore, and every industrial institution where raw materials are converted into finished or other products, or into money. In each instance *income is and must be something over and above the original capital investment plus the cost of production and sale.* This rule has been uniformly recognized by the Commissioner of Internal Revenue in the decisions and directions issued from his office for the guidance of the collectors of corporation excise taxes and of the taxpayers themselves. * * *

"If plaintiff had sold its standing timber on the first day

of January, 1909, at its market value, could it be claimed that any part of the proceeds of such sale constituted taxable income, because more was realized than the original cost in 1903? Certainly not, for the reason that the increase in value had occurred prior to the time when the excise tax law became operative. If plaintiff had purchased this timber 30 years ago, from the Government at $1.25 per acre, and had manufactured all of it into lumber and sold the lumber during the year 1909 at market prices which prevailed on the first day of that year, could it be claimed that the entire proceeds of the lumber above the trifling purchase price of the timber and the cost of manufacture and sale constituted taxable net income? Can the Government, at least in the absence of specific legislative declaration to that effect, reach back years before the enactment of this revenue statute for the controlling factor in determining the net income of a corporation? *Can it ignore a substantial increase in value of property, which has occurred and accrued prior to the taking effect of the tax law and thereby convert into income that which is not income within any meaning of the term?* To state these questions is to answer them."

"The rule of apportionment of the increment or increase of values between the years prior to January 1st, 1909, and those subsequent to that time, which has been recognized and acted upon by the Commissioner of Internal Revenue, does not aid the Government in this case, for the reason that the amounts deducted by plaintiff from its gross receipts as capital assets do not exceed the actual market value of its property on January 1st, 1909."

This case was taken to the Circuit Court of Appeals for the Sixth Circuit, where, in an opinion filed June 30, 1916, but not yet reported, which affirmed the judgment of the District Court, we find this language:

"If the property on hand at the end of the year, figured at its true inventory or market value, must be put upon one side of the income account, there can be no escape from putting the corresponding true value at the beginning of the year upon the other side of the account; and this must include raw materials which were on hand at the beginning. The law contemplates distinct periods. *Everything before 1909 must be in one period;* everything later, in another; and then, for taxing purposes, each calendar year after that date forms a distinct sub-period; the law

plainly contemplates that all income shall be definitely located somewhere. The law applied to and took effect upon business conducted after January 1, 1909; business is conducted with property; and so *the law took effect upon the body of the property existing at that date and upon the business thereafter conducted by and with the aid of that body of property.* In the later successive years, and as to some classes of property, it may serve every purpose to delay the computation or entry of income or gains seemingly existing in one year until cash realization in the next, and to do this by carrying an arbitrary but constnat inventory value; this will make no difference to the taxpayer or to the Government in the end; but not so with reference to the two main periods before and after the law took effect. In the sense in which we have seen 'income' is and must be used at the end of each taxing year, it must be used at the end of the period preceding 1909. * * * The true character of that particular accumulation on January 1, 1909, now involved, may be illustrated with reference to this corporation. To meet this $20.00 per acre increase in market value the company could lawfully have paid out a cash dividend, or a stock dividend, or it could have sold its property for the original value plus the appreciation and have distributed the entire proceeds. If this had been done on December 31, 1908, there would be no income in 1909. If the consummation were postponed for two days, upon no tenable theory could it be thought that the $20.00 appreciation would become part of the income produced by carrying on the business during 1909. We are satisfied that the necessary and practical working of the law requires, and that its words fairly permit, income for one year to be computed by the aid of comparison between the market value of the body of property on hand at the beginning and at the end of the year; and *it follows that such a market value of property existing at the commencement of the period, must be deducted from the selling price afterward received.*"

The respondents in the cases at bar had, on the first day of January, 1909, all the property which they will ever have, and that property was then valued at the full amount which they will ever receive for it. Since that date, their only receipts have been the proceeds of its disposition. Their mining contracts were a part of their invested capital and no income there-

from has been received, or, in the circumstances, has been possible. Each of the respondents owns property of the same precise value as attached to it on the first day of January, 1909, less the amount which has been received since from conversion of portions of it from real estate, or *quasi* real estate, into a cash equivalent which has been distributed, as already stated, to its stockholders.

If, instead of receiving cash for the ore taken under the contracts, the respondents had received for it lands, or other property than cash, the situation would be no different; yet, of course, the Government would not claim that in such case the value of the lands or other property must be included as gross income in the corporation tax returns.

The case of

Forty Fort Coal Company v. Kirkendall, 233 Fed., 704,

is directly in point.

In that case the coal company was required to pay corporation excise taxes upon the full value of the coal mined by it, upon the theory advanced by the defendant, as Collector of Internal Revenue, that such value represented income, whereas the coal in place was of the value of 15c per ton. Having paid the taxes the Company sued to recover the amount and secured a judgment by default. Upon an application by the defendant to vacate the judgment, *Judge Witmer* said, in respect of this question:

> "The Act of Congress requires the allowance for depreciation of property in reasonable amount. It is not denied in the petition to set aside that the plaintiff's property was depleted to the amount of 15c for each ton of coal mined. * * * It requires no argument to demonstrate that, under the tax law which makes an allowance for depletion or depreciation, if an owner has a ton of coal in the ground worth 15 cents, and he digs it up and sells it for 15 cents, *the amount so received for it is not income, but is, in fact, only a return to him of the value of his coal as part of his capital asset.*"

Thus far in this litigation the petitioner and his counsel have frankly conceded that mineral, as it lies in the ground is *capital.* No one will deny that. As far as the respondents are concerned that capital has been bargained away to others in consideration of specific payments to be periodically made, *and the obligations of such grantees of the ore to make the stated payments represent the existing capital of the Land Companies.* Whether that capital be in the form of ore or of promises to pay, it necessarily remains capital, as to them, and was such when the excise law went into effect.

During the years 1909 to 1911, the income, if any, derived from the mines accrued to their grantees; for the respondents did not extract the ore; they did not smelt it; they did not sell it; they did not realize any gain out of it; they carried on no business in respect of it. If there were income derived from the operation of the properties, the tax based thereon has been paid, presumably, by the operators.

It follows very plainly that any income in the way of gains or profits from the disposition of capital assets or their use in business, must be computed upon the basis of the value of such resources on the first day of January, 1909, since that date marks the beginning of the taxing period for which a computation of income must be made and for which only a tax can be imposed.

This was demonstrated both by *Judge Willard* and by *Judge Sanborn.*

Thus, at pages 122-3 of the transcript, in the course of his decision in the District Court, *Judge Willard* said, with reference to the corporate assets of the respondents:

> "The Commissioner seems to have made an attempt to apply to the case that part of the regulations heretofore quoted under the heading 'Sale of capital assets.' This property was all acquired prior to January 1, 1909. In applying the rule, it is necessary for him to determine the proportion of the gain which arose *subsequent to that*

date. There is no evidence to show what the value of this property was at any time before the incorporation, or at any time since. *Yet it clearly appears that there has been no gain at all, so far as these plaintiffs are concerned, since 1909.* All of the leases were made prior to that date for terms of fifty years or more. *The value of the property to the plaintiffs was then fixed and it could not be changed to their advantage during the terms of the leases.* In other words, the property was worth no more to them in 1909, 1910 and 1911 than it was in 1906, 1907 and 1908. * * * This case is to be decided upon what the actual facts are, and not upon what they appear to be. The actual facts are that nobody has made a dollar out of these properties by these incorporations."

We now quote from *Judge Sanborn*:

"In 1906 and 1907 these corporations took from the lessors the latters' claims and rights to collect and received from the lessees the royalties they had covenanted to pay for the ore, and the title to the lands, and issued their stock therefor. *If there was any gain, profit or income in this transaction, it was made in 1906 and 1907, at least two years before January 1, 1909, when the Tax Act took effect,* and the corporations were exempt from taxation on account of that income. *Merchants Ins. Co. v. McCartney,* 17 Fed., Cases No. 9443, page 46. On January 1, 1909, when the Act took effect, and for years before that date, these corporations were the owners of the claims and rights to collect and receive the amounts which the lessees had covenanted by the leases to pay for the ore in the lands, and of the lands themselves. *These things were their absolute property on January 1, 1909, and none of them was any part of their subsequent income, gain or profit.* The land was practically worthless; the rights and claims to collect the amounts the lessees had covenanted to pay for the ores were practically all there was of value in their property, and these were worth hundreds of thousands of dollars. If they had sold these claims in 1909 for cash for their actual value, for no more and no less than their actual value, *no part of that cash could have been gain, profit or income. It could not have escaped being a mere different form of their property, of their capital, and the corporations could not have been taxable on account of it"* (pages 147-8).

The conclusion thus adduced cannot be escaped. Suppose a person to be the owner, on the 31st day of December, 1908, of mineral bearing property containing a million tons of merchantable iron ore, which may have cost him, ten years before, $50,000, but which possessed a value in place, on December 31, 1908, of $250,000.00. Regardless of the original cost to him, the owner manifestly has in that property, on that day, an asset equal to the sum last named. Can the fact of the enactment of the Corporation Excise Tax Law in August, 1909, destroy that pre-existing estate? Had Congress the power, after December 31st, 1908, validly to declare that only one-fifth of it is capital, because that is all that it cost, and that the other four-fifths are income?

Suppose, again, that the owner of the property sold the same in January, 1909, for its full value of $250,000.00, which was paid in cash, and that the money was at once invested by the seller in bank stocks; can the Congress say to him thereafter, "Only one-fifth of your bank stock is capital, and the remaining four-fifths are to be deemed and taxed as income"? Yet, is the $250,000.00 any the less invested principal when in the mine than it is in the form of bank stocks? Further, can there be any question but that, in the hands of its *purchaser* in January, 1909, the mine would represent capital and nothing else? If the mine had an intrinsic value of $250,000.00, at the moment of the sale, and it is a capital investment of the purchaser in that amount, must it not necessarily have been a capital investment of the *seller* in the same amount, at the moment of the sale?

In the cases at bar the respondents are, in fact, *the purchasers*. They bought the properties in July, 1906, at their then value, and paid for them by the issuance of their capital stock, and that value has never increased since, *because it was fixed at a specific sum by the terms of the mining contracts.*

All judicial decisions have recognized and applied the rule

for which we now contend, namely, that *that is capital which is owned by a taxpayer at the time of the incidence of the tax, and that, to the extent of its value at that time, money into which the property is afterward converted, is not to be considered as income which can form the basis of taxation.*

C. B. & Q. Ry. Co. v. Page, 1 Biss., 461 (Fed. Cases No. 2668);
Reynolds v. Williams, 4 Biss., 108 (Fed. Cases No. 11734);
United States v. Smith, 1 Sawyer, 277 (Fed. Cases No. 16341);
Merchants' Insurance Co. v. McCartney, 1 Lowell, 447 (Fed. Cases No. 9443);
Gray v. Darlington, 82 U. S., 63;
Bailey v. Railroad Company, 106 U. S., 109.
Mitchell Bros. Co. v. Doyle, 225 Fed., 437;
Same case, on appeal, C. C. A., 6th Circuit, not yet reported.
Lynch v. Turrish, C. C. A., 8th Circuit, not yet reported.
Lynch v. Hornby, C. C. A., 8th Circuit, not yet reported.

Merchants Insurance Co. v. McCartney arose under the Income Tax Law of 1864. The company being a stockholder in a bank received a dividend from the bank, three-tenths of which was made up out of profits accumulated before the passage of the Income Tax Law of 1864; upon the remaining seven-tenths the bank had paid the Internal Revenue tax. The defendant, United States Collector, exacted from the plaintiff payment of the tax of five per cent upon the whole sum received, which payment was made under protest and an action brought to recover it. By the Act of 1864, a tax of 5 per cent was imposed upon the net annual income or gains of such corporations; but a deduction was permitted of income derived from dividends on shares in banks, etc., the tax upon which had been paid by the corporations declaring the dividends. The plaintiff contended that no part of the dividends paid by the bank was liable to assessment because, as to the three-tenths, it was not income, and as to the seven-tenths the tax had already been

paid by the bank. *Judge Lowell,* in sustaining this contention, said:

> "As to the three-tenths it seems to me to have been *a division of capital, a return to the plaintiffs in money of a part of the property which was already in their ownership as capital stock when the first tax act was passed.* If the Suffolk bank had been wholly wound up and had returned to its stockholders the exact value of their shares in money, *having made no profits since the passage of the original act,* this sum of money could not be taxed as income, gains or profits; and so of a part. If the plaintiffs on receiving the money chose to divide it among their own stockholders, still it is not a dividend out of gains and profits, nor out of the surplus funds, because the surplus funds that are taxable are those which are or have been made out of profits *since the passage of the act.*"

The case of *Bailey v. New York Central R. R. Co.*, 106 U S., 109, throws light upon our inquiry.

This case also arose under the Federal Income Tax Law of 1864, Section 122 of which provided:

> "That any railroad, canal, turnpike, canal navigation or slack-water company * * * that may have declared any dividend in scrip, or money due or payable to its stockholders, as part of the earnings, profits, income or gains of such company, and all profits of such company carried to the account of any fund or used for construction, shall be subject to and pay a duty of five per centum on the amount of all such interest, or coupons, dividends or profits whenever the same shall be payable."

The railway company had expended from its earnings in constructing and equipping its road and purchase of properties, an amount equal to eighty per cent of its capital stock, for which, by resolution of its Board of Directors, it was declared the stockholders were entitled to reimbursement at some convenient future period; to evidence such right certificates were thereupon issued to each stockholder declaring him entitled to receive out of future earnings, at the option of the company, eighty per cent of the amount of the capital stock held by him.

In 1870 an assessment of five per centum upon the amount of the certificates was made upon the company. The assessment was paid and suit brought to recover it. Upon the trial, the Circuit Judge charged the jury that, while the certificates constituted a scrip dividend which justified the assessment, nevertheless *it was competent for the company to show what amount of the earnings of the company, accrued since the existence of the tax law, was included in the certificates, and that this amount alone was subject to the tax.* The contention of the defendant, Collector of Internal Revenue, was, that the certificates were conclusive upon the railroad company as to the amount subject to taxation. The company recovered a judgment for the tax paid upon that part of the moneys represented by the certificates which it had earned prior to the taxing period, and this judgment was affirmed by the Supreme Court in an opinion delivered by *Mr. Justice Matthews,* in which this language occurred:

> "It should be borne in mind, in the first place, that the tax provided for in this section of the Act, is an *annual* income tax, and *its subject is the interest paid and profits earned by the company for each year, and year by year;* and that, both by the express letter of the law and its necessary implications, the tax is not laid on any of these funds *which came into being before the time prescribed in the Act.* And in the ordinary execution of the law, it was contemplated that the funds to be taxed and the tax imposed upon them would be concurrent, as to each fiscal year; the scheme of the statute being to levy the tax upon the income for the year ending on the 31st of December next preceding the assessment; and while it would be altogether admissible to go back for the purpose of assessing the tax upon a proper fund which had accrued during a previous year and escaped taxation, nevertheless, the tax imposed would be for the omitted year. But no tax, in contemplation of the law, accrues upon the fund except for the year in which the fund itself accrued. It is also to be remembered that the subject-matter of the tax is the net earnings of the company for the year for which they are taxed, which have been actually realized by it, or which the law assumes to have been."

In

Gauley Mountain Coal Co. v. Hayes, 230 Fed., 110 (C. C. A., 4th Circuit),

the court said, referring to the Act of 1909:

> "It is manifestly the purpose of this act to tax the net income for the year in which the assessment is made. The Supreme Court, in the case of *Gray v. Darlington,* 82 U. S., 63, passed on the precise question."

In the case of *United States v. Smith,* 1 Sawyer, 277 (7 Fed. Cases, No. 16341), the defendant was indicted for the crime of perjury in making a false income return for the year 1868. In that year he sold certain stocks but returned no portion of the selling price over and above the original cost, as income. In charging the jury, the Court stated that the income tax law then in force related back to the original Act of August 5, 1861, and added that:

> "—the defendant was bound to state and return for taxation as income, all gains and profits derived from the sale of stocks in 1868, whenever purchased, *so that they were purchased since August 5, 1861.*"

In other words, the value of properties existing prior to the enactment or effective date of an Income Tax Law, is the basis from which subsequent income therefrom must be ascertained.

Likewise in *C. B. & Q. R. R. Co. v. Page,* 1 Biss., 461 (Fed. Cases, No. 2668), the railroad company, prior to the tax law of July 1, 1862, had made advances to another corporation for which it had taken mortgages. After the passage of the law the mortgages were foreclosed and stock certificates were issued to the shareholders of the railroad company, representing their proportionate interest in the properties acquired under the foreclosure. It was held that the stock thus issued did not represent "dividends due and payable during the year 1862," which were made taxable by the law, *because the prop-*

erty represented thereby was capital of the corporation when the law went into effect, the Court saying:

> "These profits and earnings had then [July 1, 1862] actually been disbursed for them[the mortgages], *and they were held as a part of the general assets of the company.* * * * But the argument here is, that it is of no consequence what the actual value of the property was in November, 1862, or at the time of the advances,—though not one quarter of the money paid,—yet it must be regarded as a dividend for the whole.* * * It is plain that such a principle would reach every purchase made with its profits by the railway company in past years, either of real or personal property, added to the general stock, and any apportionment of stock so acquired, for which a certificate might be given after September 1st, 1862, showing the amount of such purchase or apportionment, and the share of the stockholder in the same. A construction which leads to such consequences ought not to be given to this statute unless the language imperatively demands it. * * * If in 1860 a man had bought an estate, or a mortgage on one, with a portion of his income for that year, he thereby added to his estate the value of the purchase. If he in that way increased his income for 1862, that would be taken into account in assessing it, but if he were then to foreclose the mortgage or perfect his title, that would only be consummating a right of property by enforcing an absolute lien. If he made sale of the property, would the proceeds become part of his income for that year, even though re-invested in another estate? * * * We think, therefore, under the circumstances of this case, these certificates of stock cannot be regarded as a dividend declared due and payable to the stockholders in November, 1862. *The company and the stockholders treated that part of the property acquired with these earnings as capital stock, and it cannot be at the same time stock added to the capital and a dividend.*"

Palpably, in the cases at bar, no corporate assets came into being after January 1, 1909, and nothing that can be called income was comprised in the moneys received by the respondents after that date. The companies and their stockholders treated their property interests under the mining contracts,—subsequently represented by the payments received during the

years in question—as capital assets. If those interests were not capital, then the corporation had no capital assets at any time; if they were capital assets when received in 1906, they were capital in 1909, 1910 and 1911 when they were liquidated by payment, and such payments constituted capital subject to reinvestment or to distribution among stockholders.

In *Reynolds v. Williams*, 4 Biss., 108 (Federal Cases, No. 11734), the facts before the Court showed that the Lafayette & Indianapolis R. R. Co. and the Indianapolis & Cincinnati R. R. Co. were duly consolidated under the laws of the State of Indiana so as to merge the two in a new corporation called the Indianapolis, Cincinnati & Lafayette R. R. Co. The plaintiff was appointed trustee of the Lafayette & Indianapolis R. R. Co. charged with the duty of adjusting its unsettled business. In that capacity he made a return of the receipts and expenditures of the company from the first of July, 1864, to the 30th day of June, 1866, the date at which it ceased to operate its road, and paid the income tax upon the net earnings of the company for that period. As a part of the consolidation arrangement, $100,000.00 of United States bonds which had been purchased by the company in July, 1863, out of previous net proceeds of operation, were held by the plaintiff as a trustee for the use of the stockholders. An income tax of five per centum, or $5,000.00, was assessed against these bonds, under the Act of 1867, as being gains, profits and income accrued to the beneficiaries in the year in which the trustee received the fund. Having paid the tax under protest, the plaintiff sued to recover it back.

The Court said:

> "It appears, then, that the one hundred thousand dollars of United States bonds was the property of the Lafayette and Indianapolis Railroad Company in the year 1863, and continued to belong to that company till its dissolution on the 8th day of January, 1867; and that on that day the plaintiff, as trustee, became, and ever since has

been, the legal owner of the bonds in question. * * * From what appears in the declaration, it is certain that the plaintiff, as a trustee, became the owner of these bonds on the 8th day of January, 1867. Before that time they were the property of the Lafayette and Indianapolis Railroad Company. On that day this company died, and by a sort of last will and testament, called in the declaration 'Articles of Consolidation' transferred the legal title to said bonds to the plaintiff as a trustee, and the equitable interest in them, as I construe the declaration, to the stockholders of said company. These bonds, so far as appears from the declaration, never were taxed in the hands of the company.

"I suppose that the 'gains, profits and income' mentioned in the act to which we have referred, are not to be regarded as an increase of the wealth of the trustee, but of the *cestui que trusts* for whom he receives and holds these gains, profits and income. I suppose, too, that the mere change from the hands of one trustee into those of another, of the fund which is the subject of the trust, would not make the whole fund, in the hands of the last trustee, gains, profits and income within the meaning of the revenue law. If this be so, then the inquiry must be, whether the one hundred thousand dollars of bonds, which in 1867 came to the hands of the plaintiff as trustee, was so much added to the wealth of the beneficiaries as a new acquisition; or whether it was not a mere change of an interest that had accrued before the year 1867 from the hands of one trustee into those of another."

The Court then concluded that, while the legal title to the bonds was never in the stockholders of the Railroad Company, yet they were the equitable owners of them and that, having been acquired in 1863 *prior to the enactment of the income tax law under which the assessment was made*, the stockholders had *an existing property right in them at the incidence of the tax law* and, consequently,

"the mere passage of this trust fund from the possession "of the old trustee, the corporation, into that of the new "trustee, the plaintiff, was not 'gains, profits or income' "accruing to the stockholders by that operation."

The recent decision of the United States Circuit Court of Appeals for the Eighth Circuit, in the case of *E. J. Lynch, Collector, v. Henry Turrish,* decided September 4th, 1916 (not yet officially reported), sustains precisely the principles which the respondents here assert. The facts in that case, as stated by the Court, were as follows:

> "The Payette Lumber and Manufacturing Company was a corporation organized in 1903 with a capital stock of $1,500,000 divided into 15,000 shares of the par value of $100.00 each of which Turrish owned in 1913 and 1914 799¾ shares of the par value of $79,975. The Payette Company began immediately after its organization in 1903 to invest its capital in timber lands in the State of Idaho and, prior to March 1, 1913, it had invested $1,375,000 thereof therein and the remainder thereof in other assets the ownership of which was incidental to the owning, holding and preservation of the timber lands. *During this time it did no business except such as was incidental to the ownership and care of these lands* and it made no dividends or payments of any kind to its stockholders. On March 1, 1913, the Payette Company still owned all the property and assets it had invested its capital in, and the value of these assets was not less than $3,000,000. The increase in the value of its property was due entirely to the gradual increase in the value of its timber lands between 1903 and March 1, 1913, and the value of the stock of Mr. Turrish was then twice its par value, or $159,950. In March, 1913, Mr. Turrish and all the other stockholders of the Payette Company gave an option in writing to purchase their stock for twice its par value. The holders of this option formed another corporation to which they transferred their option and that company preferred to purchase the property of the Payette Company to purchasing its capital stock. Thereupon, in December, 1913, that company offered to sell all its property to the Boise-Payette Company, the new corporation which held the option to purchase its stock, for $3,000,000 in cash on condition that the new company would assume its debts and liabilities. The offer was accepted and in March, 1914, the transaction was consummated. The Payette Company then had no assets but the $3,000,000 in cash and no liabilities not assumed by the Boise-Payette Company. It then distributed the $3,000,000 among its stockholders who surrendered their

stock and the corporation had since been dormant. In the distribution of the proceeds of the property of the company Mr. Turrish received $159,950, which was twice the par value of his stock. The Commissioner of Internal Revenue deemed one-half of this sum, or the par value, and the actual value in 1903, of the stock of Turrish, capital returned to him, and the other half, or the increase of the actual value of his stock between 1903 and March 1, 1913, by reason of the gradual advance during that time in the value of the timber lands of the Payette Company, income derived by him in 1914 from a dividend received from a domestic corporation subject to the income tax law. On this ground he assessed against Turrish an additional income tax of $127.12 on account of the second half of the $159,950. Turrish paid this tax under protest and brought this action for the return of the amount he paid. The court below was of the opinion that no part of this $159,950 was income taxable under the Act of October 3, 1913, and it accordingly overruled the demurrer and rendered judgment for the plaintiff."

After stating the facts as above, the Court observed that it seemed reasonable to say that the increase in the value of the Turrish stock, which had accrued prior to March 1st, 1913, on account of the gradual advance in the valuation of the corporate property prior to that date, could not be considered income, gains or profits of the stockholders taxable under the law.

> "(1) Because no income, gains or profits accrued to the stockholder during the year 1914, or after March 1, 1913; his property remained of the same value and gained nothing during that time; and (2) because the sale of the property of the corporation in 1914 and the distribution of its proceeds to the stockholders was a mere change of the form, without increase of the value, of the property he owned before the Income Tax Law took effect."

The Court then recited that the counsel for the United States contended that everything above the par value of the stock was income, (1) because the stockholder had no interest in the increased value of the corporate property until it was distribut-

ed to him by way of dividend; (2) because this distribution was made in 1914 for the first time and, therefore, became income to the stockholders, and (3) because the excess above par value was derived from a dividend received by him in 1914. These contentions were based upon the general rule that a stockholder has no legal right or title to the income, gains or profits of his corporation until a dividend has been declared.

The Court answered these contentions as follows:

> "But the tax authorized by the Act under consideration is an annual tax on the income, gains or profits arising or accruing after March 1, 1913, in the calendar year preceding the levy, and neither the rule itself nor any rational application of it is determinative of the question in what year this alleged income accrued or arose, or of the question whether the proceeds of the dividend were income or capital. If it were, then the entire $159,950 would, by the same mark, have become his income, gains and profits when the distribution was made in 1914, for it was all distributed to him by the same dividend, and until that dividend was declared he had no better legal title or right to any of the property of the corporation, or to the proceeds of any of it, than he had to the increased value of its timber land."

The Court then declares that although it is true that a corporation holds the legal title of, and the right to manage and control, its property, nevertheless the stockholders are the equitable and beneficial owners of all of its property, and the corporation is the mere holder and manager of it for them; the benefit of every increase in its value is the benefit of the stockholders, and the injury of every decrease of value is their injury. Continuing, it said:

> "Whether the value of the property of a corporation is increased by a gradual advance through a series of years of the value of the same real or personal property held throughout, or by undivided income, gains or profits, the actual value of its stock is immediately and proportionately increased and the holders of that stock may at any time convey their respective beneficial interests in that enhanced value, in those undivided profits, and in all the

other property of the corporation by sale, gift or devise. *The Collector v. Hubbard*, 12 Wall., 1. The position that a stockholder in a corporation has no interest in the enhanced value of its property or in its undivided income, gains, profits or surplus until a dividend thereof is declared, is untenable and may not prevail. * * * All the value of the property of a corporation and all the value of the stock of the plaintiff, whether it was due to capital assets, or income, or gains, or profits, or all of these combined, had arisen and accrued and had become their property before March 1, 1913. * * * The provisions of this law that the normal tax shall be levied annually upon the net income arising or accruing in the preceding calendar year * * * ending December 31st, except that for the year ending December 31st, 1913, it shall be computed upon the net income accruing from March 31st to December 31st, leave no doubt that *the Congress intended to and did exclude* from the burdens of the taxes it imposed by the Income Tax Act of October 3, 1913, *all income, gains and profits of every kind which had arisen or accrued prior to March 1, 1913.* It clearly intended to leave, and surely did leave, all the income, gains and profits which had accrued or arisen prior to that date, whether they were in the form of divided or undivided surplus, income, gains or profits, as free from every income tax it imposed, and as absolutely the property of their respective legal and equitable owners, as was any of their original capital or property. Now, the subsequent change by sale, distribution or otherwise of the form of the property held on March 1, 1913, without thereby enhancing its value or causing any gain, profit or income to its holders, as from real to personal property, or from stock to cash, does not subject it to the income tax, because it produces no gain, profit or income; it leaves the value of the property the same after as before the change. And as the sale of the property of the Payette Company in 1914, and the distribution of its proceeds to its stockholders by the dividend did not enhance the value of the property of the corporation or of the stockholders, or produce any gain, profit or income for them, but left the value of their property the same that it was before those transactions and the same as it was when the Income Tax Law took effect, the declaration and payment in 1914 of the dividend by which the proceeds of the sale of the property of the corporation were distributed to its stockholders did not transform the increased value of the plaintiff's stock which had accrued and arisen prior to March 1, 1913, into

> income, gains or profits accruing or arising subsequent to that date, and did not subject it to any income tax."

The principles thus so clearly expressed, apply to and control the cases at bar. The maximum value of the properties of the respondent companies was attained with the execution of the last mining contract on January 2, 1907, by the Sargent Land Company. From that time until January 1, 1909, that value was constantly diminishing as payments under the contracts were made, and the ultimate amounts receivable thereunder were thereby diminished. Whatever was received by the respondent companies after the first of January, 1909, was merely a conversion into money of the pre-existing values of the corporate assets, impossible, under the terms of the contracts, of increase or gain; and the distribution of such moneys to their stockholders constituted, as to them, a mere return of their invested capital as it stood at the effective date of the excise law.

The reasoning of the following additional sentences from the opinion of the Circuit Court of Appeals in the *Turrish case* is convincing here:

> "It is so inequitable, so unjust, so discriminatory to treat such an enhanced value accruing through many years before the enactment of an income tax law as the income, gains or profits of the year in which it happens subsequently to be distributed, that the following rule which is supported by the more forcible reasons and by the great preponderance of authority has become the established law in the Federal Courts. The enhanced value of property which accrues from the gradual increase in its value during a series of years prior to the effective date of an income tax law, although divided or distributed by dividend or otherwise subsequent to that date, does not become income, gains or profits taxable under such act. Such enhanced value, like the property of which it is an outgrowth and in which it inheres, becomes the absolute property of its legal and equitable owners before the effective date of the law and, as against such a law, thereafter remains their capital assets. *Gray v. Darlington,* 15 Wall., 63, 65, 66, 67; *Sargent Land Co. v. Von Baumbach,* 207 Fed., 423,

432; *Von Baumbach v. Sargent Land Co.*, 219 Fed., 31, 36, 37, 134 C. C. A. 649, 654, 655; *Gauley Mountain Coal Co. v. Hays*, 230 Fed., 110; *Industrial Trust Co. v. Walsh*, 222 Fed., 437; *Mitchell Bros. Co. v. Doyle*, 225 Fed., 437, 439, 440; *Doyle v. Mitchell Bros. Co.* (6th Circuit), filed June 3, 1916; *Hudson's Bay Co. v. Stevens*, 25 L. T. R., 709, 5 Tax Cases, 424, 436, 438, 439; *Tebrau (Johore) Rubber Syndicate, Ltd., v. Farmer*, 47 Scot. L. R., 816, 5 Tax Cases, 658.

"Because no income, gains or profits accrued to the plaintiff during the year 1914, or after March 1, 1913, but during that time his property remained of the same value, and because the sale of the property of the Payette Company in 1914 and the distribution of its proceeds by a dividend to its stockholders was but a change of the form, without any increase of the value, of the property he owned before the Income Tax Law of 1913 took effect, there was no error in the judgment below and it is affirmed."

At the same time with the decision in the *Turrish case*, a decision was handed down by the Circuit Court of Appeals for the Eighth Circuit in the case of

Lynch, Collector, v. Hornby,

the facts in which differed somewhat from those in the case of Turrish, the distinction emphasizing the soundness and force of the principles declared in the former opinion. Inasmuch as neither of these opinions has been as yet officially reported, the following somewhat extended excerpt from the opinion in the *Hornby case*, is here inserted:

"Hornby was the owner of 434 shares of the capital stock of the Cloquet Lumber Company from 1906 until 1915. That company was a corporation of Iowa which for more than a quarter of a century has been engaged in purchasing timber lands, manufacturing the timber into lumber and selling it. It had a capital stock of $1,000,000 divided into 10,000 shares of the par value of $100 each. On March 1, 1913, by the increase of the value of its timber lands and by its business operations it had become possessed of property which was worth four times the par value of its stock or $4,000,000, its timber had become worth ten dollars per thousand feet, and the stock of Mr. Hornby, the par value of which was $43,400, had become worth at least $150,000. In the year 1914 the Cloquet Company was en-

gaged in converting its standing timber into money and distributing it among its stockholders by cutting the timber, manufacturing it into lumber and selling the lumber. In that year it distributed to its stockholders in dividends $650,000. Of these distributions $240,000, or 24% of the par value of its capital stock, was derived from the net earnings and profits of the company during the current period, and $410,000 was derived from moneys realized during the year 1914 by the Cloquet Company from the conversion into money by it of property which it owned, or in which it had an interest, on March 1, 1913. Hornby received during the year 1914 $10,416 from the distribution of these net earnings and profits of the company and $17,794 out of the distribution of these moneys realized from the conversion into money of the property which the Cloquet Company owned or had an interest in on March 1, 1913. The property out of which the $410,000 was realized was of the value of $410,000 on March 1, 1913, and the conversion of it into money and the distribution thereof diminished the value of the Company's property as it was on March 1, 1913, by that amount, and diminished the value of Mr. Hornby's stock as it was on March 1, 1913, and increased his cash, $17,794. In his income tax return for the year 1914, Mr. Hornby included the $10,416 he received out of the income and profits of the Cloquet Company during that year and he paid an income tax without protest upon a computation which included this amount, but he did not include the $17,794 which he received out of the moneys realized in 1914 by the Cloquet Company from the conversion into money of property which it owned or had an interest in on March 1, 1913. The Commissioner of Internal Revenue deemed this $17,794 taxable income to Mr. Hornby and on account of it levied an additional tax of $171 which Mr. Hornby paid under protest and brought this action to recover.

"Counsel for the United States complains that the complaint does not state facts sufficient to constitute a cause of action because it does not state the original cost of the timber or other property which the Cloquet Company acquired before and owned on March 1, 1913. But that omission is immaterial because it does state the value of the property which that Company owned and was interested in on March 1, 1913, which was converted into money and distributed to its stockholders in 1914, and that this conversion and distribution diminished the value of its property as it was on March 1, 1913, and as it was just before the conversion and distribution, by $410,000, and

diminished the value of Mr. Hornby's stock as it was on March 1, 1913, and as it was just before the sale and distribution, by $17,794. As none of the property which the Cloquet Company or Hornby held on March 1, 1913, whether it was original capital or previously earned surplus, income, gains or profits, was intended to be made or was made taxable as income by the Income Tax Law of 1913, the complaint stated facts sufficient to show that this $17,794 was not so taxable."

For the reasons stated in the opinion in the *Turrish case,* and because no income or gain accrued after March 1, 1913, by the conversion into money of the timber owned by the company to the extent of $410,000, and because the effect of that conversion and distribution was simply to change the form of a part of the property which Mr. Hornby owned on March 1, 1913, from capital stock into $17,794 of money, the judgment was affirmed.

Inasmuch as the Cloquet Lumber Company, after March 1, 1913, actively engaged in the business of manufacturing its standing timber into lumber and disposing of the same, the line was necessarily drawn between the distribution of its converted capital at its value on March 1, 1913, and the distribution of earnings during the tax period. No question could be raised respecting the liability of the stockholder to pay an income tax upon the earnings so distributed to him, and, with equal certainty, no liability to taxation attached to him in respect of that portion of the distribution which represented the value of his invested capital on March 1, 1913.

In *Gray v. Darlington,* 82 U. S., 63, the short facts, as stated by the Court, were as follows:

The plaintiff was the owner of certain treasury notes which he exchanged in 1865 for United States bonds. He sold the bonds in 1869 at an advance over the cost of the treasury notes of $20,000.00, and an income tax of five per centum was assessed against him upon this amount under the Act of March

2nd, 1867, upon the assertion that the $20,000.00 were gains, profits and income of the plaintiff for the year 1869.

The Court held:

"The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits or income of the plaintiff *for the year in which the bonds were sold.* The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of the property during a series of years can, in no just sense, be considered the gains, profits or income of any one particular year of the series, *although the entire amount of the advance be at one time turned into money by a sale of the property.* The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits and income. Its general language is 'that there shall be levied, collected, and paid *annually* upon the gains, profits and income of every person,' derived from certain specified sources a tax of five per cent., and that this tax shall be 'assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December, next preceding the time for levying, collecting, and paying said tax.' (14 Stat. at Large 477-8, Sec. 13.) This language has only one meaning and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. * * * (p. 65).

"The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceeds the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes

place. We are satisfied that no such result was intended by the statute" (pp. 66-67).

The whole theory of the Act of 1909 is that it "does not impose direct taxation upon property solely because of its ownership" (*Flint v. Stone-Tracy Co.*, 220 U. S., 150), but "the tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed" (Id., 162). "And the measure of the tax is the income, with the deduction ($5,000) stated" (Id., 146).

In other words, those employing "the advantages which inhere in the peculiarities of corporate or joint stock organization" (Id., 146) pay an excise tax therefor *measured by the benefits* which they derive from the use of such advantages in each tax year.

Did the respondents derive any benefit by any corporate action, or by the exercise of "the particular privilege of doing business in a corporate capacity" (Id., 151), during any of the years 1909, 1910 and 1911? Were not all the moneys accruing to them secured by the execution of the mining contracts years before?

What were the benefits, if any, received by the respondents? The Commissioner of Internal Revenue contends that all of the moneys received under the contracts in the years in question were benefits in the form of gross income by which the tax of the respondents should be measured. His contention, therefore, must be that the moneys received during each of said years were the product of exercising the privilege of doing business in a corporate capacity during the same, and that they were not only gross income, but were gross income *derived from doing business in those years.* If, however, they were the result of corporate action in the years 1906 and 1907, and were received by the corporations without any further or other act upon their part during the three years here involved, how can they be charged as gross income for those three years? For

"if business is not done in the manner described in the statute, no tax is payable" (220 U. S., 152).

Regulations of Treasury Department Relating to Computation of Income.

As soon as might be after the enactment of the Excise Law, the Secretary of the Treasury issued a circular, under date of December 3, 1909, (Treasury Decision No. 1571), embodying regulations in respect of the corporation tax and setting out, in part, the Government's interpretation of the law. In that circular we find the following language:

> "Article 2—*Gross income.* The following definitions and rules are given for determining the gross income for the various classes of corporations:
>
> 1A. *Banks and other financial institutions.* * * *
>
> 1B. *Insurance companies.*—Same as 1A above.
>
> 2. *Transportation companies.*—same as 1A above.
>
> 3. *Manufacturing companies.*—Gross income received during the year from all sources will consist of the total amount, ascertained through an accounting, that shows the difference between the price received for goods as sold and the cost of such goods as manufactured. * * *
>
> 4. *Mercantile companies.*—Gross amount of income received during the year consists of the total amount ascertained through inventory, or its equivalent, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge, to the account, of the sum of the inventory at the beginning of the year, and a credit to the account of the sum of the inventory at the end of the year.
>
> 5. *Miscellaneous.*—Gross income consists of the gross revenue derived from the operation and management of the business and property of the corporation making the return, together with all amounts of income * * * derived from all other sources, as shown by the entries on the books from January 1 to December 31 of the year for which return is made.
>
> It will be noted from these definitions that gross income is practically the same as gross profits, the only difference being that gross income is more inclusive, embracing, as it does, not only gross profits of the corporation but also all amounts of income from other sources.

6. *Sale of capital assets.*—In ascertaining income derived from the sale of capital assets, if the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income, according to whether the selling price was greater or less than the buying price. *If the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion shall be deducted from or added to the gross income for the year in which the sale was made.*"

By Treasury Decision No. 1588, January 24th, 1910, an additional exposition of the Act was given as follows:

"The provisions of the law require—

1. That the return shall show *the gross income (profit) received during the year*, which is reported in item 3 on form 637. * * *

To make a correct return it is necessary for the accountant to know—

1. The exact resources and liabilities of a corporation *both on January 1 and December 31 of the year covered by the same.*

2. A full statement of the business transacted during the year.

For example: * * * *A business transaction that results in exchanging these assets, or any part of them, for anything of equal value does not produce income.* * * *

Any increase or decrease in value accruing at a time prior to January 1st of the calendar year for which return is made, cannot be taken as a part of the gross income from that year, but, as noted above, such increase or decrease in value should be included in the account of the prior calendar year. * * * And it is not at all material in making a return for the year 1909 if * * * the goods were purchased prior to that time. *On January 1st, 1909, the goods referred to constitute capital assets* at the invoiced value, and *only the profits* on the same, if sold during the year, *are taken as gross income*, or if not all sold during the year, gross income is found by an addition to the credit side of the account of the sum of the inventory at the close of the year."

Again, in Treasury Decision No. 1606, March 29th, 1910, we find:

"72. Depreciation in value of mines *by the removal of ore, if not otherwise ascertainable,* may be pro-rated as in the case of sales of capital assets.

"75. Corporations leasing mines [lessees] and paying royalties on ore mined are not entitled to deduction for depreciation. *But corporations owning mines are entitled to allowance for depreciation based on fair estimate,* etc.

"76. Removal of timber from timber lands, while depleting the lands to the extent of such removal, *is regarded as a change in the form of assets* and not a depreciation within the meaning of the Act."

In Treasury Decision, No. 1675, February 14, 1911, rules were laid down as follows:

"55. *Lands bought previous to January 1st, 1909, and* sold during the year 1910, *should have the profits arising from such sale pro-rated in accordance with the number of years the land was held by the corporation and the number of years the law was in effect,* if no accounting of increased value of land was made in returns for previous years.

"75. A mere removal of timber by cutting from timber lands, unless the timber is otherwise disposed of through sales or plant operations, is considered simply *a change in form of assets.* If such timber is disposed of through sales or otherwise, it is to be accounted for in accordance with regulations governing *disposition of capital and other assets.*

"83. *An estimate should be made January 1, 1909,* of the fair market value at that date of the mineral, etc., in deposit. This estimate should be formed on the basis of the disposal value of the minerals in total and exclusive of value of improvements and development work. This valuation should also be reduced to a unit value—per ton, barrel, etc.

"*Note.*— * * * The value to be determined as stated must be on the basis of the saleable value of the entire deposit of the aggregate units of minerals considered *en bloc, if disposed of in that form.* Nor must such valuation comprehend any speculative value which might attach to a sale of the minerals *en bloc,* i. e., a value which might be obtained on the ground that the future would develop a much greater reserve

of mineral deposits than were believed to exist at the time the estimate of January 1, 1909, was formed. Any value of this latter character would attach obviously to such additional reserves when developed in future.

"84. *The unit value as of January 1, 1909,* ascertained as above outlined, would indicate the value to be attached at that date to the capital assets disposed of during any calendar year succeeding, and should be used in determining *the unearned increment at January 1, 1909, which may be excluded entirely from the item of gross income,* as before explained, in the following manner, viz:

Value at January 1, 1909, determined in manner outlined, of minerals, etc., which may be removed and disposed of in any year subsequent thereto, $.....

Less the following:

(a) Proportion of depreciation charge applying to exhaustion of minerals disposed of, ascertained as first explained herein on basis of original cost, $.....

(b) Royalty paid, if any, on minerals disposed of, $.....

Balance, being unearned increment at January 1, 1909, to be excluded from gross income item $.....

In Treasury Decision No. 1706, June 9, 1911, with reference to the disposition of *securities,* it is provided that, where no entry of appreciation is made on the books, the gain accruing upon a sale of the securities shall be pro-rated according to the number of years the securities were held prior to sale, and *the amount so apportioned for each year after January 1, 1909, "the beginning of the period when the corporation excise tax law became effective" shall be accounted for as income.*

Likewise, in Treasury Decision No. 1742, December 15, 1911, we find:

"62. In the case of lands bought prior to January 1, 1909, and sold during any subsequent year, the profits arising from such sale, if no accounting of increased value of land was made in return for previous years, should be pro-

rated in accordance with the number of years the land was held by the corporation and *the number of years the law was in effect.*"

Treasury Decision, No. 1742 constituted a revision of former regulations, paragraphs 97, 98, 101, 103 and 105 of which are of interest at this point, and read as follows:

"97. In the ascertainment of net income deduction will be allowed for depreciation arising from exhaustion of deposits of ore, mineral, etc., and for depreciation and obsolescence of improvements, in accordance with general regulations respecting depreciation allowances, on the basis of *the original capital investment cost* of the properties concerned to the company reporting.

"98. A further deduction will also be allowed, through not including the same at all in the item of gross income, for *the unearned increment* represented in such properties as at January 1, 1909.

"101. * * * The question as to whether it subsequently develops [that] the property possessed a greater quantity of mineral, etc., reserve than was, in the aggregate, estimated as of January 1, 1909, is immaterial. Any excess which may be developed will be considered as possessing the same value at January, 1909, as that which then may have been known to be in the property.

"103. As the amount to be deducted for depreciation is to be formed on the basis of the estimated reserve of minerals, etc., it follows that if it develops [that] such estimate is understated, the cost investment in the capital assets may be wholly extinguished before all mineral reserves are removed. When this is reached, *further deductions for exhaustion of minerals should be discontinued,* but in such event it will be noted, the allowance for unearned increment, which is to be excluded entirely from gross income, will be correspondingly increased.

"105. In respect to properties of the character in question, which may be acquired by a corporation *after* January 1, 1909, a deduction will be allowed only as to depreciation arising from exhaustion, *based on original cost; no exclusion from gross income can be made for unearned increment, as profit arising from any sale of such capital assets applies wholly to the period subsequent to January 1,1909.*"

ing and mercantile companies were all permittted to deduct from their gross receipts the value of their assets used in manufactures or sold in the course of trade; and, as to corporations other than manufacturing and mercantile companies, the rule was expressly laid down that "gross income consists of the "gross revenue *derived from* the operation and management of "the business and property of the corporation making the re- "turn."

The words "derived from" in that definition, as in the definition given by *Mr. Justice Pitney* in *Stratton's Independence, Ltd., v. Howbert* ("Income may be defined as gain derived from capital or labor or from both combined"), mean, and can only mean, *produced by* or *gained out of*, the property, or capital, leaving that intact.

It will be observed, from an examination of the Treasury Decisions which have been quoted, that the Commissioner of Internal Revenue established, as an inelastic regulation, the rule of ratable apportionment, to the years intervening between their acquisition and sale, of the increased values of corporate assets; and that he exempted from taxation that proportion of such increased values as attached to the years preceding January 1, 1909.

We have seen that, under the decisions of the Federal Courts, only the *actual* increase after the date of the incidence of a tax of this character can be taken into account, and that all increment preceding that date represents at that time (as far as the tax law is concerned) invested capital.

Does not the rule of apportionment promulgated by the Commissioner necessarily concede this? It pro-rates the increased value over the years elapsing between purchase and sale, and exempts the proportion allotted to the period prior to January 1, 1909. This can only be for the reason that any increment accruing before that date must be recognized to be capi-

tal investment and not income; hence, only the proportion *assumed* to have accrued after January 1, 1909, is directed to be classed as income to afford a measure for taxation.

The error of the Commissioner lies in making an arbitrary determination by proportion instead of ascertaining *the actual fact.*

Bailey v. R. R. Co., 106 U. S., 109, *supra.*
Gray v. Darlington, 82 U. S., 63.

If, in fact, the entire increase in value in a given case accrued before January 1, 1909, then, of course, it was all part of the taxpayer's invested capital at that date, for he could turn it into money at that value before the law became effective, and it represented his financial worth and property so far as that particular item was concerned.

Doyle v. Mitchell Bros. Co., C. C. A., 6th Circuit, *supra.*
Lynch v. Turrish, C. C. A., 8th Circuit, *supra.*

Applying the principle underlying the regulations referred to to the cases now before the Court, it is seen that, from the time the mining contracts covering the respondents' lands were executed, the value of the ore sold under those contracts being fixed and inflexible, the value of the respondents' rights in the contracts was likewise fixed, and that there was no advance or gain or profit possible thereafter.

It is accordingly submitted that, during the years 1909, 1910 and 1911 the respondents received no gross income and were not liable to pay an excise tax for those years.

POINT IV.

The Respondents Derived no Net Income for the Years 1909, 1910 and 1911; and, herein, the question of "Depreciation."

On the 31st of December, 1908, the respondents, respectively, were the owners of the legal title to certain lands in Minnesota, subject to outstanding contracts, by virtue of which *other parties* owned the exclusive right of occupancy and control of the premises, paid all taxes and assessments levied upon or against the same, and possessed the similar exclusive right of mining, removing, owning and selling all iron ore that might be in the lands.

The excise law became effective as of January 1, 1909. Since that date the respondents have engaged in no business, have made no investments of any kind, and, as rapidly as their property has been converted into money, have distributed it to their stockholders in pursuance of the chief purpose of their organization.

The mining contracts referred to were, in effect, conditional contracts of sale effectual to prevent any control, use or subsequent disposal of the ores by the respondents as long as the grantees in the contracts observed the conditions therein expressed. The fact that the contracts may be terminated at some time in the future through a default of the grantees, or by their election to surrender the same, is an entirely immaterial consideration. There is no presumption of such a situation arising, and, should the contracts be terminated, an entirely new situation would be created the effect of which could only be determined thereafter. In the case of *McCoach v. Minehill Co.*, 228 U. S., 291, 304, this was expressly recognized when, speaking of the lease made by the Minehill Company of its railway properties, this Court said that the effect was,

"—to constitute the Reading Company the public agent for the operation of the road and to prevent the Minehill Company from carrying on business in respect of the maintenance and operation of the railroad *so long as the lease shall continue.*"

The respondents have no power to terminate the contracts so long as their terms are observed by the grantees therein, and, during their continuance in force, can receive from the properties only the sums covenanted to be paid thereunder. Should it happen that the properties again come into their possession and control, the liability of the respondents to pay a tax will be a question then to be determined, depending upon the manner in which they may see fit to handle or dispose of the properties.

State Line Co. v. Davis, 228 Fed., 246.

These contracts fixed a definite and unchangeable price for the ores beyond which the respondents were entitled to, and could, look for nothing more. The value of their capital assets therein on January 1st, 1909, as represented by their interest in the lands, was precisely what it was on the 31st day of December, 1911 (the end of the period with which these suits are concerned), except for the diminution therein by payments made under the contracts. By those payments the obligations to pay, represented by the contracts, were correspondingly reduced. On January 1st, 1909, the respondents had all of the property which they ever will have, and their only receipts have been the proceeds of its diminution and exhaustion. It is accordingly evident that they have had no gross income whatsoever in the sense in which that term must be interpreted. Their iron contracts (which are the source of their receipts) are a part of their invested capital. If their cash receipts had been retained in the treasuries of the companies, each company, on the 31st day of December, 1911, would have owned exactly the same amount of property, or capital, that it owned

on the first day of January, 1909, less the incidental expenses incurred in the interim.

The fact that the companies distributed these capital receipts to their stockholders as soon as they came in, is immaterial from any point of view. The depletion of the invested capital arises from the reduction in value of the assets represented by the contract obligations, through the periodic payments made thereunder, and not from the distribution of those payments, when received, to stockholders.

It has resulted in these cases that the values of the capital assets of the respective land companies on the 31st day of December, 1911, were smaller than they were on the first day of January, 1909, by the amounts shown on page 17 of this brief, the same being the amounts received and distributed by each of the companies for the three years. It thus conclusively appears that the stockholders of the Sutton Land Company, by way of illustration, owned, at that date, $75,310 less than they owned on January 1, 1909, because the value of their contracts had been reduced by payments thereunder in that aggregate sum. And so of the other companies.

The accuracy of these statements is self evident.

Net Income: How Computed.

The excise law imposes upon corporations organized for profit a special excise tax with respect to the carrying on or doing of business by such corporation, "equivalent to one per "centum upon the entire *net income,* over and above $5,000.00, "received by it from all sources during such year, exclusive of "amounts received by it as dividends of stock of other corpora-"tions."

It is further provided that such *net income* shall be ascertained by deducting from "the *gross* amount of the income" of the corporation all ordinary, necessary expenses actually paid

within the year *out of income;* all losses sustained within the year and not compensated by insurance or otherwise; "a reasonable allowance for depreciation of property, if any"; interest paid within the year, to a limited amount; taxes paid within the year, and all amounts received as dividends upon stock of other tax-paying corporations.

The law necessarily assumes a *gross income*, and, unless there be a gross income, no net income, susceptible of being used as a measure of an excise tax, can exist. It has been demonstrated, we think, that these respondents had no gross income.

We are confronted, however, by the insistence of the petitioner that the *gross receipts* of the respondent companies constituted *gross income*, and, except for the insignificant deductions for expenses and taxes, and the specific deduction of $5,000.00 per year, became the measure of the tax to be imposed by the Commissioner. We cannot assent to, and have already discussed, this phase of the case.

If, however, it be assumed that the claim of the Treasury officials is correct, the question arises

Are the Respondents not entitled to an Allowance for Depreciated Value of their Invested Capital?

Respecting this inquiry (which was not considered by the District Court), the Circuit Court of Appeals said, at page 154 of the transcript:

> "If there were error in the conclusion that the receipts of the companies from their collections of the amounts of their claims against the lessees, which came due in 1909, 1910 and 1911 for the purchase price of, or the royalties on, the ore, were not included in their gross income, if they were a part of that gross income, then the companies would have been entitled to 'a reasonable allowance for depreciation of property' by the reduction of the values of their claims by these payments. *Strattons' Independence, Ltd., v. Howbert,* 231 U. S., 399, 418. And as the payments on

these claims unavoidably reduced and depreciated their value, as has been shown, by the amounts paid, there would have been no net income from them on account of which an excise tax could have been lawfully exacted. *United States v. Nipissing Mines Company,* 202 Fed., 803, 805; *Stevens v. Hudson's Bay Company,* 101 L. T. Rep., 96, 97, 98."

See, to the same effect,
Forty Fort Coal Co. v. Kirkendall, 233 Fed., 704, quoted on page 140 *supra.*

If the mineral properties and contracts were capital assets of the corporations, and if their values were lessened by the removal of, and payment for, ore by the lessees, then the provision for a deduction of a reasonable allowance for depreciation immediately becomes operative, as a matter of right conferred upon the respondents by the Act of August 5th, 1909.

How is Depreciation Arrived At?

We refer again to paragraph 6 of the Regulations of the Treasury Department, issued December 3rd, 1909:

"6. *Sale of Capital Assets.*—In ascertaining income derived from the sale of capital assets, * * * if the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price, is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909 * * *."

Also paragraph 97 of the Regulations issued December 15th, 1911:

"In the ascertainment of net income, deduction will be allowed for depreciation arising from exhaustion of deposits of ore, minerals, etc., and for depreciation and obsolescence of improvements, in accordance with general regulations respecting depreciation allowances, on the basis of the original capital investment cost of the properties concerned to the company reporting."

The Commissioner has never revoked or repudiated these regulations, either generally or with reference to the present

cases.

The position of the Commissioner, in the cases at bar, has been, up to this time, only that the respondents were entitled to no allowance for depleted values of their capital assets *because no depreciation account was kept by them and no reduction of capital values was entered upon their books.*

The examination of the witness *Schouler,* the accountant of the Treasury Department who made the investigation of the books and records of the respondents, shows this very clearly. We quote from the record, at pages 108, 110 and 111:

> "*Direct Examination.* Q. Did you find upon the books of either of the plaintiff companies, any claim for depreciation?
>
> "A. Nothing on the books at all.
>
> "Q. There was no depreciation charged on the books?
>
> "A. No, sir.
>
> "*Cross Examination.* Q. But isn't it a fact, speaking broadly, that the difference between the account which you claim is correct, the account made up by you, and the account filed by the companies for the same year, is in the amount claimed by the companies to be allowed for depreciation, consisting of the amounts received by them on account of ore sold, on account of lands sold, and, in some cases, on account of timber sold?
>
> "A. In some cases that is possible.
>
> "Q. But speaking generally, the difference between your account and theirs was that they claimed for depreciation of the property on account of sales of ores, sales of lands and sales of timber?
>
> "A. The difference between the original and the other return is the claim for depreciation. * * *
>
> "Q. Is it or is it not a fact that you, in making up what you call the correct return for these companies, omitted all the items of depreciation for the reason that, under their system of bookkeeping, they did not maintain a so-called depreciation account?
>
> "A. It is a fundamental principle that they [the Treasury Department] will not accept any claim for depreciation unless it is evidenced by some reduced value of assets.
>
> "Q. That was the sole ground of objection to the depreciation items found in the returns made by the companies; it was the fact that their books did not have any depreciation account?

"A. That is the practical question. It must be on the books first; afterwards it is decided on its merits.

"Q. If there had been a depreciation account kept in the books of these companies would you have looked into it?

"A. I would have gone into the matter as fairly as possible, threshed it out and put it up to the Department.

"Q. Would you have made, in what you call your correct return, an allowance for depreciation?

"A. Yes, sir, I would have made a return based upon my examination. * * *

"Q. The fact is, is it not, that you struck out any allowance, in what you called the correct return, on account of depreciation because there was nothing shown on the books, and it was left to the Commissioner? Please answer yes, or no.

"A. I can't answer your question yes, or no, because of the peculiar conditions. * * * My figures are simply based upon the fact that there is no depreciation on them [the books]. * * *

"Q. You know the Commissioner claimed that you had gone into this on its merits; but as far as that report was concerned, you intended that as a report of what the books showed?

"A. My return threw out the claim because it was not evidenced."

The "fundamental principle" of the Department, referred to and applied in these cases, clearly proceeds upon the doctrine of estoppel.

An estoppel is such an act, admission or declaration as precludes its author from saying the truth. It precludes the truth in order to prevent fraud and falsehood and to protect innocent parties relying upon the acts, admissions or declarations of another; it imposes silence upon a party only when, in conscience and honesty, he should not be allowed to speak.

Van Rensselaer v. Kearney, 11 How., 297.

The rule, of course, is universal that estoppels, to be good, must be mutual; that is, an estoppel can be invoked only by one who, but for its invocation, would be damnified. No more than in the case of one of its citizens, will the Government be

allowed to exact payment of an unjust claim by the application of an alleged estoppel.

The "fundamental principle" of the Department, applied in these cases, results in this very thing.

The negative act of the respondents of omitting to keep depreciation accounts in their books is, by the Commissioner, made conclusive against the fact of any depletion or depreciation. The effect of the enforcement of such a rule is the exact opposite of what an estoppel produces; it imposes silence when, in conscience and honesty, a party should be allowed to speak.

The Commissioner's Power to Prescribe Regulations Does Not Authorize Him Thereby to Enlarge the Statute.

Morrill v. Jones, 106 U. S., 466;
United States v. Symonds, 120 U. S., 46;
United States v. United Verde Copper Co., 196 U. S., 207;
Williamson v. United States, 207 U. S., 425.

In the case first cited, section 2505 of the Revised Statutes provided that animals imported for breeding purposes should be admitted free of duty under such regulations as the Secretary of the Treasury should prescribe. The defendant imported certain animals for breeding purposes and was required to pay duty, because the Collector was not satisfied that they were of superior stock. This court said:

> "The Secretary of the Treasury cannot, by his regulations, alter or amend the revenue. All he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted. In the present case, we are entirely satisfied that the regulation acted upon by the Collector was in excess of the power of the Secretary. The statute clearly includes animals of all classes. The regulation seeks to confine its operation to animals of superior stock. This is manifestsly an attempt to put into the body of the statute a limitation which Congress did not think it necessary to prescribe."

The aptness of this declaration to the situation in the present cases is striking. Although the Congress has granted to every corporation subject to the excise tax a deduction from gross income on account of depreciation, the Commissioner has attempted to amend the law by adding a *proviso* that such depreciation must be shown upon the books of the company.

In the *Symonds case,* a regulation of the Secretary of the Navy resulted in reducing the salary to which an officer was entitled under the law, by prescribing that certain services rendered aboard ship should be regarded as shore service. This court said, in holding the Secretary's regulation invalid:

> "All the different kinds of service described therein are services performed at sea, in the meaning of §1556. But they are to be deemed such, not because the Secretary of the Navy has announced that the Department will so regard them, but because they are, in fact, services performed at sea, and not on shore. If the regulations of 1876 had not recognized services 'on board a practice ship at sea' as sea service, the argument in behalf of the Government would imply that they could not be regarded by the courts, or by the proper accounting officers, as sea services; in other words, that the Secretary of the Navy could fix, by order, and conclusively, what was and what was not sea service. But Congress certainly did not intend to confer authority upon the Secretary of the Navy to diminish an officer's compensation, as established by law, by declaring that to be shore service which was, in fact, sea service, or to increase his compensation by declaring that to be sea service which was, in fact, shore service. The authority of the Secretary to issue orders, regulations and instructions, with the approval of the President, in reference to matters connected with the naval establishment, is subject to the conditions, necessarily implied, that they must be consistent with the statutes which have been enacted by Congress in reference to the navy. He may, with the approval of the President, establish regulations in execution of, or supplemental to, but not in conflict with, the statutes defining his powers, *or conferring rights upon others.*"

The Act of 1909 gave to every corporation paying taxes under its provisions the deduction of a reasonable allowance for de-

preciation, not as a matter of grace, in the discretion of the Commissioner, but as a right expressly conferred whenever such depreciation might take place, *in fact*.

In the *United Verde Copper Company case*, an act of Congress permitted the cutting and removal of timber from public lands for building, agricultural, mining or other domestic purposes. The Secretary of the Interior promulgated a regulation that no timber could be used for smelting purposes. In an action brought to recover the value of the timber cut and removed from public lands by the defendant and used for smelting ores, this Court said (pages 214-15):

> "The government relies on the rules and regulations of the Secretary of the Interior, promulgated under, as it is contended, the authority of the statute since *United States v. Richmond Mining Company* (40 Fed., 415) was decided. No. 7 of those regulations provides that 'no timber is permitted to be used for smelting purposes, smelting being a separate and distinct industry from that of mining.' By this the Secretary of the Interior may have intended to supersede the ruling in *United States v. Richmond Mining Company*, but to which industry the roasting of ore shall be assigned the Secretary does not say, and the considerations which we have expressed apply as well to the regulation as to the statute. But there is a more absolutely fatal objection to the regulation. The Secretary of the Interior attempts by it to give an authoritative and final construction to the statute. This, we think, is beyond his power. * * * If Rule No. 7 is valid, the Secretary of the Interior has power to abridge or enlarge the statute at will. If he can define one term, he can define another. If he can abridge, he can enlarge. Such power is not regulation: it is legislation. The power of legislation was certainly not intended to be conferred upon the Secretary."

Williamson v. United States was a case involving a regulation of the Commissioner of the General Land Office requiring an entryman under the Timber & Stone Act of June 3rd, 1878, to make oath, *on final hearing*, of his *bona fides* in making his entry and of the absence of contract or agreement in respect of the title. The law required an applicant for *entry* to swear

to his good faith and to the absence of any speculative purpose, but the requirement was not re-imposed in respect of final proof. The Commissioner, however, exacted such affidavit with final proof. This Court said (pages 461-2):

> "It remains only to consider whether it was within the power of the Commissioner of the General Land Office to enact rules and regulations by which an entryman would be compelled to do that at the final hearing which the act of Congress must be considered as having expressly excluded, in order thereby to deprive the entryman of the right which the act by necessary implication conferred upon him. To state the question is to answer it. * * * True it is that in the concluding portion of §3 of the timber and stone act it is provided that 'effect shall be given to the foregoing provisions of this act by regulations to be prescribed by the Commissioner of the General Land Office,' but this power must, in the nature of things, be construed as authorizing the Commissioner of the General Land Office to adopt rules and regulations for the enforcement of the statute, and cannot be held to have authorized him, by such an exercise of power, to virtually adopt rules and regulations destructive of rights which Congress had conferred."

The effect of the regulation of the Commissioner of Internal Revenue that no depreciation will be recognized unless it be evidenced by book entries, is to deprive tax-paying corporations, which have not seen fit to adopt a system of bookkeeping that embraces such entries, of the deduction expressly given to them by the Act of August 5th, 1909.

Accordingly, it is submitted:

The Requirement of Depreciation Entries in Corporate Books is Arbitrary and Futile.

Judge Willard, in the District Court, said: "Nor do I attach any importance to the fact that, upon the books, the companies carried no 'depreciation' account." (Page 122).

In *Doyle v. Mitchell Bros. Company*, already referred to, decided by the Circuit Court of Appeals, Sixth Circuit, June 30th, 1916, but not yet reported, the Court said:

"There is nothing magical in bookkeeping; it does not create facts; it only records them. A citizen cannot be rightly taxable in one way if he keeps books and in another way if he keeps none; nor in one way if his books are accurate and kept up to date, and in another way if they are imperfect and neglected. Book entries may be of value as an admission when a tax is to be assessed and when there is a dispute as to the fact, but they cannot work as an estoppel as to an undisputed fact. The insistence of the Commissioner that this $20.00 an acre appreciation is income for the year in which the timber happens to be cut rests at last upon the theory that the taxpayer is estopped to claim that it was income for an earlier period because he had not so entered it on his books; and this theory we cannot accept. Its formal transfer into surplus or undivided profits account would have done nobody any good or any harm. Until this law was passed, it was a matter of indifference to the corporation and to the stockholders whether profits were entered up at one time or another, and any attempt after August, 1909, to make a book entry of these gains, *nunc pro tunc,* as of December, 1908, would only have invited adverse comment. On this subject there cannot be one rule for a corporation and another for an individual. If this property had continued to be owned by the partnership which preceded the corporation, there might have been no capital account representing the land and timber. The existence or not of such an account would have been incidental to the bookkeeping system adopted. It is only the existence of the capital stock of a corporation which compels the maintenance of an account showing the corresponding assets. So, we find ourselves unable to give any controlling force to the fortuitous circumstances that, in this case, the capital account was carried under the name of 'Land and Timber,' and that the accretions had not been entered."

In *United States v. Nipissing Mines Company,* 202 Fed., 803, the same view was taken by Circuit Judge *Lacombe,* who said:

"The suggestion that there can be no allowance for depreciation unless such depreciation is entered in the books of the company, recorded from time to time, seems to me without force. The books may be very badly kept, kept in such a way as will in the end bring them into trouble and difficulty; *but this act does not provide any penalty for bad bookkeeping.* It simply provides that one per cent.

of the net profit of the various corporations shall be turned over to the Government, and provides that in finding out that net profit there shall be a reasonable allowance for depreciation."

In *Baldwin Locomotive Works v. McCoach*, 215 Fed., 967, we find:

> "More actually insolvent business ventures have been made to appear nominally profitable by bad bookkeeping than in any other way. A manufacturing concern, for instance, which is a fit subject for proceedings in bankruptcy, may be made to show large nominal profits by the fraudulent expedient, or honest mistake, of charging repairs, which properly belong in the expense account, up to a machinery or other capital account and thus be made to figure as assets. By the reverse process of bad bookkeeping all profits may be made to disappear. Proper bookkeeping, therefore, involves in this respect the highest judgment, and 'profit' and 'loss,' 'capital' account become mere bookkeeping terms. * * * The observation applies to the bookkeeping act of how the books show that a particular piece of property possesses a certain value. The bookkeeping system or business policy may be adopted of charging up all the property acquisitions of the corporation at the cost price irrespective of any estimated value it may have. The policy may be adopted of having the book account follow all the variations and vagaries of the market."

In that case the corporation, at some time after the Act of 1909 was approved, caused its property to be re-valued, and entered upon its books certain properties which it had possessed but which had never theretofore been entered, resulting in a large increase in book assets. The Commissioner of Internal Revenue imposed an excise tax upon the basis of such book entries, asserting that the increased valuation thus shown was taxable income for the year in which it was made. This contention was overruled by the Court. We quote further from the opinion (page 971):

> "The first question to be determined, therefore, is whether the amount of net income is to be determined according to mere bookkeeping facts or according to the real facts

of gross income and the actual payments thereout for the purposes specified in the Act. This must be determined from the language employed by Congress. If the amount is to be determined by the mere bookkeeping facts, then it is difficult to escape the conclusion that we must take the facts from the books as kept, assuming, of course, their integrity and that they are kept in good faith. No other bookkeeper, governmental official or otherwise, could be permitted to manufacture a different set of bookkeeping facts for the plaintiff. If the amount is to be determined by the real facts, then a judicial inquiry must be made which will disclose them."

The decision in this case was afterward affirmed by the Circuit Court of Appeals for the Third Circuit in

McCoach v. Baldwin Locomotive Works, 221 Fed., 59.

Judge McPherson, writing the opinion of that Court, said:

"We agree with the District Court that this increase of valuation was not income within the meaning of the statute. Nothing whatever was added to the corporate property, which remained exactly the same after the appraisement as before. The only thing done was to put upon the company's books an expression of expert opinion that certain property was worth a certain sum, and this can hardly be said to be income, or even gain, in any proper sense. The company could not become either richer or poorer by making a few book entries that merely recorded a new estimate of how much it was worth."

A similar situation was presented, and determined in the same way, in

Industrial Trust Company v. Walsh, 222 Fed., 437.

In the case of *Forty Fort Coal Company v. Kirkendall,* 233 Fed., 706, a suit brought to recover an excise tax claimed to have been unlawfully exacted, where it was claimed by the defendant Collector that no depreciation account was kept upon the books and that the amount claimed for depreciation was carried on the books as surplus account, the Court said:

"It is not denied in the petition to set aside that the plaintiff's property was depleted to the amount of 15 cents for each ton of coal mined. *The sole ground of the Gov-*

ernment's claim is based on the book entry made in 1912 or 1913, and corrected in 1914. The decisions under the excise tax law and under the income tax law are uniform in effect that the Government cannot base a claim for taxes on mere bookkeeping. *Industrial Trust Company v. Walsh,* 227 Fed., 437; *Baldwin Locomotive Works v. McCoach,* 215 Fed., 967; *Id.,* 221 Fed., 59. In the latter case it was decided by the Circuit Court of Appeals for this Circuit that mere appraisement of property by a corporation on its books cannot form the basis of assessment of taxes on net income, even though the books show that during the tax year the value of the property was increased by the amount on which the government claims the regular rate of tax. The plaintiff here has admitted that during the year 1912 and 1913 a certain amount of money was carried on the books of the company in surplus account, but insists that such amount should have been properly noted on the books as depletion reserve. In the statement of claim, however, the truth of which is in no way disputed, it was specifically averred that the amount so temporarily shown on the books as surplus was not properly surplus, or net income, or profit, but was merely a return of capital asset, being an amount which represented the minimum value of the coal in the ground."

The foregoing quotations are convincing of the lack of either legal or practical foundation for the rule of the Department relied upon by the witness Schouler.

Chief Justice Waite, in considering the liability to taxation of a railroad company under the Act of Congress of July 14, 1870, imposing a tax of 2½% on profits not divided but used for construction, said:

> "This is to be ascertained, not by inquiry into the manner of keeping railroad accounts, but by interpreting the language of Congress at different times to give expression to its will; not by determining whether, as a matter of bookkeeping it is used to carry undivided profits used for construction to a construction fund, but by studying the several statutes to see if it was intended that, if so used, they should be taxed under the Act of 1870."
>
> *Marquette, H. & O. R. R. Co. v. United States,* 123 U. S., 722.

In the court below it was said in the same case (17 Fed., 721):

> "In bookkeeping, within the meaning of the Act of 1870, net earnings or undivided profits are added to a particular fund by proper transfer entries in the books of account. But the object of the statute is not defeated if profits used for construction are not carried into the proper account on the books; for, within the meaning of the statute, and according to common understanding and experience, they must be considered as added to construction fund, if they are used for construction."

We may, therefore, dismiss as unimportant the regulation of the Commissioner respecting the keeping of a book account of depletion or depreciation.

The Question of Depreciation is one of Fact.

The only consideration, then, is, as held in the cases just cited, and, with especial emphasis, in *Bailey v. Railroad Company*, 106 U. S., 109: What is *the actual fact* in relation to the diminution in value of the respondents' assets?

> "It is entirely consistent with the declaration itself to show, *in point of fact*, what was the amount of earnings accrued during the period while the Income Tax Act was in force, which had not been assessed for taxation as profits carried to construction or other account. *The declaration in the certificates could not be conclusive of anything not inconsistent with it, for an estoppel only prohibits contrary allegations.* The proof admitted on the trial below did not contradict the certificates but only served to rebut a presumption, which, as a matter of law, was not conclusive. Its tendency and effect were to exact from the company the full tax upon every dollar of its earnings which had not previously paid its proper assessment and which, in any form, was subject to taxation, and to relieve it only to the extent to which, otherwise, it would have been subjected to the payment of a second tax upon the same fund. This result and the process by which it was reached seem to us strictly to conform both to the letter and the spirit of the law governing the subject" (106 U. S., 117).

As pointed out by *Judge Dickinson* (215 Fed., 967, 969, 972), the provision in the Act of August 5, 1909, for a deduction by way of a reasonable allowance for depreciation, would not be justified were it not expressly mentioned, and, being expressly mentioned, it cannot be disregarded.

It is perfectly plain that, when the last ore shall have been mined and removed by their grantees from the lands of the respondent companies, and the last payment shall have been made under the contracts therefor, the substantial assets of the respondents will have become exhausted and the value which their capital stock had at the time of the transfer to the companies of the mineral properties, or at January 1, 1909, will have become entirely depleted. If that original value represented at any time the capital investment which the stockholders of the land companies owned, then it is manifest that, by the payments made under the contracts, the assets which gave value to their capital investment have been depreciated. If the capital assets have been depreciated, then their owners are, beyond peradventure, entitled to an allowance therefor. And since that depreciation arises, palpably, through the periodic payments upon the contracts constituting the assets, and since each payment produces a corresponding depreciation in capital value, it follows that the deduction authorized to be made to counteract that depreciation is exactly measured by the payments which caused it.

The income tax law approved September 8th, 1916, contains, in Section 12, the same provision for a reasonable allowance for depletion in the case of mines, and (repealing the hasty and ill-considered limitation thereon contained in the Act of October 3rd, 1913, generally regarded as unconstitutional) prescribes that such allowance shall not exceed "the market "value in the mine of the product thereof which has been mined "and sold during the year for which the return and computa-

"tion are made." This is not only the just allowance, but the only reasonable allowance which can be made, if exhaustion of natural deposits is to be compensated for.

It is an important fact in this legislation that the Congress has now recognized the true rights of property owners and has so legislated as to prevent further doubt or misconstruction respecting this reasonable allowance for depletion or depreciation.

We think it fair to assert that the enactment quoted was intended to be taken as an interpretation of the Congressional purpose respecting an allowance for depletion of natural resources, and to set at rest the controversies concerning it.

Attention is particularly directed to certain provisions of Section 10 of the Income Tax Law of September 8th, 1916. In defining, in that law, the term "dividends," the Congress provided that it shall be held to mean any distribution made by a corporation "out of its earnings or profits *accrued since March 1st, 1913*"; and, in the last paragraph of the same section, it has declared that, for the purpose of ascertaining the *gain* derived from the sale or other disposition by a corporation of its property acquired *before* March 1st, 1913, "the fair market "price or value of such property, as of March first, nineteen "hundred and thirteen, shall be the basis for determining the "amount of such gain derived or loss sustained."

Likewise, in Section 12, in respect of deductions to be made from the gross amount of corporate income, it is provided that, in the case of mines, a reasonable allowance for depletion thereof, not to exceed *the market value in the mine* of the product thereof which has been mined and sold during the year for which the return and computation are made, shall be deducted "provided, that, when the allowance authorized * * * "shall equal the capital originally invested, or, in case of pur- "chase made *prior* to March first, nineteen hundred and thir- "teen, *the fair market value as of that date*, no further allow-

"ance shall be made."

March 1st, 1913, was the date of incidence of the Income Tax Law of October 3rd, 1913, and, just as that law was attached to, and an enlargement of the Act of August 5, 1909, the Act of September 8th, 1916, is an extension of the former law. The provisions of the last named act, to which we have just referred, demonstrate clearly the understanding and intention of the Congress that property values then existing, regardless of original cost and without reference to any apportionment of increase during the years of ownership by a taxpayer, represented the capital investment of the taxpayer on March 1st, 1913. The Act also recognizes that the increment accruing up to the date named could not be taxed as income for the reasons already stated in this brief.

Now the same considerations apply with equal force to the operation and enforcement of the Excise Law of August 5th, 1909, and that only can serve as a basis for the excise tax which represents net income derived from earnings or profits accruing to a corporation *since January 1st, 1909;* or gains derived from the sale or other dispositions of property which, if it were acquired before January 1st, 1909, must be determined upon the basis of the fair market value of such property on that date.

It results that, if the gross receipts of the respondents from their mining contracts, instead of being deemed mere conversion of capital (as they contend is the case), are to be reckoned as "gross income," the allowance to them on account of the depreciation contemplated by the Act must be the amount by which the capital value of the contracts on January first, 1909, has been diminished, because the respondents have that much less receivable under the contracts.

Stratton's Independence, v. Howbert.

The case of *Strattons' Independence, Ltd., v. Howbert,* 231 U. S., 399, has been greatly relied upon, and singularly misconstrued, by the representatives of the Government in the cases which have arisen in the lower court under the Act of August 5, 1909, involving mining properties.

There is nothing in the opinion of this Court filed in that suit which destroys or conflicts with the contentions of these respondents. On the contrary, as far as it goes—and it, designedly, goes a very short way—it sustains their position fully.

It will be borne in mind that, in the cases at bar, the Government's claim has been that the *entire proceeds* derived by the respondents under the mining contracts for the disposition of the ore upon their lands represent gross income and embrace no sums representing return of capital assets, and the opinion in the *Strattons' Independence case* is relied upon to sustain this claim.

It is necessary, therefore, to examine that case with some care.

The plaintiff there was a gold mining corporation actively engaged in searching for, mining and removing ore found upon its own property, which it reduced in its smelter, afterwards selling the bullion derivative. Upon the trial of the case in the District Court, it was stipulated by the counsel for the respective parties as a fact, concerning which no further evidence was offered or received in the case, that the difference between the gross selling price of the ores and the cost of extracting, handling, smelting and selling the same was the value in place in said mine of such ores before the extraction thereof, and that no value was added to said ores so extracted and sold by and through the said operations, or any of them, in excess of the actual cost of such operation.

In an opinion filed by the trial judge, it was held: (1) That

the mining company was carrying on or doing business, and came within the scope of the Act; (2) that the *net receipts* derived from the working of the mine were the net *income* by which the excise tax of the company should be measured; and (3) that the company was not entitled to reduce the amount of the net receipts, as the basis for measuring the tax, by deducting any sum for depletion of capital assets. The case having been taken to the Circuit Court of Appeals for the Eighth Circuit, that Court certified the same to the Supreme Court and submitted for its opinion three questions, as follows:

> 1. Does Section 38 of the Act of Congress entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5th, 1909, apply to *mining corporations?*
>
> 2. Are the proceeds of ores *mined by a corporation from its own premises* income within the meaning of the aforementioned Act of Congress?
>
> 3. If the proceeds of ore sales are to be treated as income, is such a corporation entitled to deduct the value of such ore in place and before it is mined, as depreciation within the meaning of Section 38 of said Act of Congress?

The Supreme Court answered the first two questions in the affirmative and the third question in the negative; but an analysis of the opinion of the court discloses that, with the possible exception of the answer to the first question, the decision cannot be taken, and was not intended to be taken, as one of general application, but was confined exclusively to the individual case, leaving the questions open for further consideration by the Supreme Court on a fuller record, which will enable their complete examination.

The corporation in that case was a *mining company which operated its own mines,* and the inquiries of the Circuit Court of Appeals were confined to a corporation of that character, as was the reasoning and dicision of this court. *The respondent companies are not operating companies,* or engaged in any other

active business. As the court declared, *a mining corporation is actually engaged in business;* in its digging, tunneling, hoisting, treating and selling of ores, it employs both labor and capital in transmuting a part of its realty into personalty, processes equivalent to manufacturing. Nothing of the kind appertains to these defendants; they are not mining companies in any sense, but simply owners of mineral lands; they have no part in, or control over, the operations on their lands; the object of their organization and existence is simply to receive and distribute to their stockholders the receipts from the various contracts under which their ores were disposed of long before the law of 1909 came into existence. Such disposition is effecting, as the ores are mined, a sale of their mineral estates and a conversion of the same into money, and the transactions belong to the class particularly distinguished by the Supreme Court from the class which Stratton's Independence, Limited, illustrated when it declared, *the sale outright of a mining property "might be fairly described as a mere conversion of the capital from land into money"* (page 414).

Rarely is a decision seen in which so great care is taken not to seem to set a precedent; the court industriously limited its decision to the facts before it, and to the special cause in which they appeared. The operations of the company being "business," it necessarily followed, in the judgment of the court, that the revenue therefrom must be deemed gross income, since that was the end and aim of its peculiar business. There is an obvious analogy between such business and a life-estate in an opened mine, since the proceeds from sales of ore produced therefrom are the only income of which the business of operating a mine, like such a life estate, is capable; and in each case it is manifestly the only income contemplated. Not so, however, in the instance of a mere sale of mineral rights by a proprietor, to be exploited and won by the purchaser; in such case, "the sale outright of a mining property might be fairly

described as a mere conversion of the capital from land into money." "For," to quote again from *Mr. Justice Pitney,* "'income' may be defined as the gain derived from capital, from labor, or from both combined" (page 415). The respondent companies were not employing either capital or labor in any adventure, hence could derive no gain (or income) therefrom.

If Strattons' Independence, Limited, instead of working its own mine, had "leased" it to another corporation which had conducted the business of mining out the ore, it is manifest that both companies could not at the same time be carrying on or doing the business of its operation; one or the other of them would be liable to pay the excise tax therefor, *but not both.* Can there be any question as to which of them it would be? And since it is clear, under the *Howbert* decision, that the corporation which is operating must pay the tax, it is equally clear that the decision has no application in the case of the original proprietor, to fix the liability upon him also. Thus, in the instance of the respondents' properties, their "lessees" who may be extracting the iron ore have been required to pay the excise tax, and, by that very fact, the defendants are relieved from liability therefor. The "lessees" are taxable because they are carrying on and doing business for a profit. And this is justified and explained by *Mr. Justice Pitney,* in these words (page 416):

> "The conduct of such business [mining] results in profit, for it cannot be seriously contended that the ores are not worth more at the mine mouth than they were worth in the mine, plus the cost of mining."

The same reasoning that defines what is income, as respects the lessees, demonstrates that the purchase price paid by them for the ore in the ground represents, as respects the fee owners who have sold it, "a mere conversion of their capital from land into money." That, even in the case of a *mining* corporation *operating its own property,* a deduction for depletion of the natural deposits should be allowed *when properly ascertained,* was

declared by this Court, as has already been noted, at pages 417-18, viz:

> "Congress no doubt contemplated that such corporations, amongst others, were doing business with wasting capital, and for such wastage they made due provision in declaring that, from the gross income, there should be deducted (*inter alia*) 'all losses actually sustained within the year,' including 'a reasonable allowance for depreciation of property, if any,' etc."

This was again emphasized, at page 421, as follows:

> "It was, of course, contemplated that income might be derived from the employment of property in business, and that this property might become more or less exhausted in the process; and because of this, a reasonable allowance was to be made for depreciation of it, if any."

In the case of owners of mines *who are also operating them*, the "net *receipts*" from sales of ore are made up of two elements: one, the profit from mining; the other, the moneys representing the conversion of capital from ore into money, the propriety of the deduction for which, in arriving at the *net income*, is expressly recognized by the Act.

In the case of owners whose mines are operated by others, under a contract of sale or license, it is too clear to admit of discussion that some portion, if not all, of the royalties received must represent the value of the ore in place, and, as such, is converted capital.

In both cases it follows of necessity that only so much of the selling price or royalties as may be *in excess of the capital investment included in them*, is income which can be considered in assessing a tax based upon income; and it was for this reason that allowance for depletion of capital was expressly provided for in the Act.

It is evident then that this court did not decide, or intend to decide, in the *Strattons' Independence case*, that *all* of the moneys derived by an operating company from sales of ore, less only the expenses of operation, represented *net income* upon

the basis of which a tax must be paid; nor, in the case of fee owners who have sold their ores under contract to operating companies, that all of the moneys derived from such disposition is net income to them. *This court merely went so far as to express its dissent from the proposition that the difference between gross receipts of the disposition of ores, and the costs in connection with the mining and handling of the ores, represented the value of the ores in place in the mine.* As stated by *Mr. Justice Pitney*, at page 418, the question before the court was to be read "in the light of the issue that is presented to the Circuit Court of Appeals for determination, as recited in the certificate."

> "From that certificate it appears that the case was submitted to the trial court and a verdict directed upon an agreed statement of facts, and in that statement the gross proceeds of the sale of the ores during the year were diminished by the moneys expended in extracting, mining and marketing the ores, and the precise difference was taken to be the value of the ores when in place in the mine.
>
> "It is clear that a definition of the 'value of the ore in place' has been intentionally adopted that excludes all allowance of profit upon the process of mining, and attributes the entire profit upon the mining operations to the mine itself. In short, the parties propose to estimate the depreciation of the mining property attributable to the extraction of ores according to principles that would be applicable if the ores had been removed by a trespasser." (Pages 419-20).

Refusing to approve this mode of calculation, the court added (at the bottom of page 422):

> "It would, therefore, be improper for us at this time to enter into the question whether the clause 'and a reasonable allowance for depreciation of property, if any,' calls for an allowance on that account in making up the tax, where no depreciation is charged in practical bookkeeping; or the question whether depreciation, when allowable, may properly be based upon the depletion of the ore supply *estimated otherwise than in the mode shown by the agreed statement of facts herein;* that to do this would be to attribute a different meaning to the term 'value of the

ore in place' than the parties have put upon it, and to instruct the Circuit Court of Appeals respecting a question about which instruction has not been requested and concerning which it does not appear that any issue is depending before that court."

It is thus seen that the decisions of this court is not susceptible of the construction which has been urged for it in this and in other cases before the courts; that it was industriously confined to determining the matters presented to it by the certificate of the Circuit Court of Appeals, and that it specifically refused to express any opinion outside of the matters so presented. The only proposition of general application announced by the decision was that the net proceeds of the product of a mine operated by the owner do not represent converted capital alone but may include also some gain or income, and that the court will not sustain a contention to the contrary even though that contention be stipulated by the representatives of both parties to the suit,—at least where one of the parties is the Government and the question of Government revenue is directly involved.

The court did, however, in arriving at this conclusion, declare certain principles which may well be considered here. Thus, at page 415:

> "But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing *capital* and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process, * * * the *gains* derived from it are properly and strictly the income from that business; for 'income' may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor. * * * It is, of course, true that the revenues derived from the working of mines result, to some extent, in the exhaustion of the capital. * * * Although it may be foretold from the beginning that the manufacture will be profitable only for a limited time, at the end of which the capital value of the plant must be subject to

One additional suggestion may be permitted, namely: That the court in the *Stratton's Independence case* was considering only the status of a mining corporation *operating its own mines* —that is to say, the manufacturer and seller of the marketable product. The respondents in these cases occupied an entirely different situation. Undeniably, the mineral property, as originally owned by their grantors, was capital; when disposed of under the contracts, those contracts and the moneys payable thereunder were substituted therefor; the original owners did not attempt to manufacture the raw material as it existed in place in the mine, but disposed of it irrevocably, in consideration of certain specified payments of money, before the excise law was contemplated; the respondents took title to the property subject to such contracts; they did not mine the deposit; they did not convert it into merchantable ore; they did not sell the ore; they did not receive the proceeds of such sale, in which alone any gain, profit or income was embraced; and all of such income and gain, if any, was received by and belonged to their vendees, who have made their due returns and paid the excise tax based thereon.

There can be no doubt that the term "depreciation" as used in the Act was intended by Congress to carry its accustomed meaning. The word has, and from its deriviation can have, but one definition as employed in the act, namely: *reduction of worth* (Century Dictionary). It is impossible that Congress meant, in the connection in which the word is used, the restricted and technical meaning sometimes given to it, namely, loss of value occasioned by wear and tear, or obsolescence, as of machinery; or the reduction of worth in physical structures and improvements occasioned by accident, use, or action of the elements. As the term appears in the Act of August 5th, *it relates to all properties of every description*, whether structures erected by man, or natural mineral deposits, or contracts

calling for payments of money, making up the assets of taxable corporations; it embraces reduction in worth however occasioned, by diminution, depletion or exhaustion, as much as by wear and tear.

The question then, when reduced to its lowest terms and as applied to the facts in these cases, is:

Does a partial payment made upon an obligation of whatever kind, calling for the payment of money, reduce the worth of the obligation?

To ask the question is, of course, to answer it.

So long as the grantees, or lessees, who hold the mining contracts covering the respondents' lands, retain the same and fulfill their terms, those contracts are practically *bills receivable* in the hands of the respondent companies *and represent their interest in the mineral deposits.* All that the respondents can exact from their contractees is the payment of the moneys becoming due under the terms of the contracts. Although they are nominally the owners of the mineral properties, the properties are subject to the conditional contracts of sale, *and the moneys received by the respondents, under such contracts, are not receipts from conducting the business of mining, or from smelting ores, or from the sale of ores or metals, but are payments in reduction of the obligations evidenced by the contracts constituting their invested capital, and a mere change in the form of their corporate assets.* To that extent, the amount so received by the respondents is deductible from their gross receipts in any taxing year, if those gross receipts can be held to be gross income.

If the corporate owner of an interest in mineral deposits should dispose of it for a lump sum paid in cash, it is indisputable that such sum would represent its invested capital converted into another form; and, if such sum were thought to be gross income, to the extent that its mineral capital would be

depleted or depreciated by the sale, the corporation would become entitled to the deduction for depreciation provided for in the Act.

If, on the other hand, such owner should dispose of its mineral commodity for a stated price, payable in periodical instalments instead of cash, there would result, just as clearly, a disposal of capital assets, and the maturing payments, when made, would represent just as clearly the corporation's invested capital converted into another form. And, with equal certainty, to the extent to which that capital would be diminished by the payments received, such owner would become entitled to the deduction for depreciation allowed by the law, if, by any form of reasoning, the payments could be held to be gross income.

It cannot be said that, because payments are deferred, they lose their character of converted capital. It has never been considered that a partial payment upon the principal of a bill receivable does not represent the money invested therein; nor has it ever been asserted that the purchase money payable under an executory contract for the sale of land does not represent a conversion of capital assets when it is received by the vendor, nor that the value of the contract as an asset is not correspondingly depreciated.

It accordingly follows that, if this court should be of the opinion (and should so declare) that the moneys received by the respondents under their mining contracts can be deemed gross income in whole or in part, they are entitled to deduct therefrom, as the reasonable allowance for depreciation specified in the statute, the full amount of the moneys so received, upon the ground that they represent a mere transmutation of capital assets, being, in legal effect, the selling price of the respondents' rights in the mineral deposits which were a part of their capital on the first of January, 1909, and which, by virtue

of the mining contracts then outstanding, had been previously sold for the exact amounts of such receipts.

POINT V.

CONCLUSION.

It is respectfully submitted that the judgments of the Circuit Court of Appeals were right and should be affirmed.

November 20, 1916.

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FILED
DEC 13 1916
JAMES D. MAHER
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1916.

No. 286.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, PETITIONER,

vs.

SARGENT LAND COMPANY, A CORPORATION.

No. 287.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, PETITIONER,

vs.

SUTTON LAND COMPANY, A CORPORATION.

No. 288.

FRED VON BAUMBACH, COLLECTOR OF INTERNAL REVENUE, PETITIONER,

vs.

KEARSARGE LAND COMPANY, A CORPORATION.

OPINIONS REFERRED TO IN ARGUMENT.

JOHN R. VAN DERLIP,
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KEARSARGE LAND COMPANY, A CORPORATION.

OPINIONS REFERRED TO IN ARGUMENT.

Decision.

(September 4, 1916.)

Dividends Declared or Assets Distributed Subsequent to March 1, 1913, from Profits Acquired Prior to that Date Do Not Constitute Taxable Income.

United States Circuit Court of Appeals, Eighth Circuit.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PLAINTIFF IN ERROR,

vs.

HENRY TURRISH, DEFENDANT IN ERROR.

In Error to the District Court of the United States for the District of Minnesota.

Before Sanborn, Adams, and Carland, Circuit Judges.

Statement.

This writ of error was sued out to reverse a judgment which the plaintiff below, Turrish, recovered against Lynch the collector, for the return to him of $127.12, which the collector had assessed against him as an additional income tax under the Tariff Act of October 3, 1913, c. 16, Sec. II, 38 Stat. 166; 3 U. S. Comp. Stat. 1913, Secs. 6319, 6320, 6321, and which he had paid under protest. The facts were alleged in the plaintiff's complaint and admitted by demurrer. The Payette Lumber and Manufacturing Company was a corporation organized in 1903 with a capital stock of $1,500,000 divided into 15,000 shares of the par value of $100 each of which Turrish owned in 1913 and 1914 799¾ shares of the par value of $79,975. The Payette Company began immediately after its organization in 1903 to invest its capital in

timber lands in the State of Idaho and, prior to March 1, 1913, it had invested $1,375,000 thereof therein and the remainder thereof in other assets the ownership of which was incidental to the owning, holding and preservation of the timber lands. During this time it did no business except such as was incidental to the ownership and care of these lands and it made no dividends or payments of any kind to its stockholders. On March 1, 1913, the Payette Company still owned all the property and assets it had invested its capital in, and the value of these assets was not less than $3,000,000. The increase in the value of its property was due entirely to the gradual increase in the value of its timber lands between 1903 and March 1, 1913, and the value of the stock of Mr. Turrish was then twice its par value, or $159,950. In March, 1913, Mr. Turrish and all the other stockholders of the Payette Company gave an option in writing to purchase their stock for twice its par value. The holders of this option formed another corporation to which they transferred their option and that company preferred to purchase the property of the Payette Company to purchasing its capital stock. Thereupon, in December, 1913, that company offered to sell all its property to the Boise-Payette Company, the new corporation which held the option to purchase its stock, for $3,000,000 in cash on condition that the new company would assume its debts and liabilities. The offer was accepted and in March, 1914, the transaction was consummated. The Payette Company then had no assets but the $3,000,000 in cash and no liabilities not assumed by the Boise-Payette Company. It then distributed the $3,000,000 among its stockholders who surrendered their stock and the corporation had since been dormant. In the distribution of the proceeds of the property of the company Mr. Turrish received $159,950, which was twice the par value of his stock. The Commissioner of Internal Revenue deemed one-half of this sum, or the par value, and the actual value in 1903, of the stock of Turrish, capital returned to him, and the other half, or the

increase of the actual value of his stock between 1903 and March 1, 1913, by reason of the gradual advance during that time in the value of the timber lands of the Payette Company, income derived by him in 1914 from a dividend received from a domestic corporation subject to the income tax law. On this ground he assessed against Turrish an additional income tax of $127.12 on account of the second half of the $159,950. Turrish paid this tax under protest and brought this action for the return of the amount he paid. The court below was of the opinion that no part of this $159,950 was income taxable under the Act of October 3, 1913, and it accordingly overruled the demurrer and rendered judgment for the plaintiff.

SANBORN, *Circuit Judge, after stating the case above, delivered the opinion of the Court.*

Is the amount in excess of the par value, and of the actual value of his stock in 1903, derived by a stockholder of a domestic corporation subject to the Income Tax Law (38 Stat. 166, c. 16, Sec. II; 3 U. S. Comp. Stat. 1913, Secs. 6319, 6320, 6321), exclusively from the increase in the value of his stock prior to March 1, 1913, the effective date of that act, on account of the gradual advance in the value of the property of the corporation prior to that date, but first realized by him in cash by the distribution in 1914 by a dividend to all the stockholders of the corporation of all the proceeds of the sale in March, 1914, of all the property of the corporation, income, gains or profits of the stockholder taxable under that law? The negative answer to this question seems at first to be reasonable (1) because no income, gains or profits accrued to the stockholder during the year 1914, or after March 1, 1913; his property remained of the same value and gained nothing during that time and (2) because the sale of the property of the corporation in 1914 and the distribu-

tion of its proceeds to the stockholders was a mere change of the form, without increase of the value, of the property he owned before the Income Tax Law took effect. Counsel for the United States, however, contend that the $79,975 which measures the increase in the value of the stock of the plaintiff between 1903 and March 1, 1913, derived from the gradual advance during that time of the value of the timber land of the corporation is taxable as his income (1) because he had no interest in the increased value of the property of the corporation until the dividend which distributed the proceeds of the sale of its property was declared in 1914, (2) because upon this distribution and not before he first obtained an interest in this increased value and thus in 1914 for the first time, it became income to him, and (3) because this $79,975 was derived from a dividend received by him in 1914. To sustain the first two contentions counsel invokes the general rule that a stockholder has no legal title or right to the income, gains or profits of his corporation until the dividends of that income, or of those gains or profits, have been declared, and cites *Hyatt v. Allen*, 56 N. Y. 553, and like cases in support of that rule. But the tax authorized by the act under consideration is an annual tax on the income, gains or profits arising or accruing after March 1, 1913, in the calendar year preceding the levy, and neither the rule itself nor any rational application of it is determinative of the question in what year this alleged income accrued or arose, or of the question whether the proceeds of the dividend were income or capital. If it were, then the entire $159,950 would, by the same mark, have become his income, gains and profits when the distribution was made in 1914, for it was all distributed to him by the same dividend and until that dividend was declared he had no better legal title or right to any of the property of the corporation or to the proceeds of any of it than he had to the increased value of its timber land.

It is true that a corporation holds the legal title of, and the right to manage, control and convey its property and that a

stockholder is without that title and right. But, after all, the corporation is nothing but the hand or tool of the stockholders in which they hold its property for their benefit. They are the equitable and beneficial owners of all its property and it is the mere holder and manager of it for them. The benefit of every increase in the value of its property is their benefit and the injury of every decrease of the value of its property is their injury. They may by appropriate action at any time require and compel it to sell all its property and to distribute its proceeds among them, and may thus strip it of all its capital, all its income, surplus, gains and profits and leave it penniless. So in reality, as against its stockholders, a corporation has no, and they have all, the beneficial interest in its property. Every substantial increase in the value of its property immediately and proportionately increases the actual value of their stock and every substantial decrease of its value immediately and proportionately decreases the actual value of their stock. Whether the value of the property of a corporation is increased by a gradual advance through a series of years of the value of the same real or personal property held throughout, or by undivided income, gains or profits, the actual value of its stock is immediately and proportionately increased and the holders of that stock may at any time convey their respective beneficial interests in that enhanced value, in those undivided profits and in all the other property of the corporation by sale, gift or devise. *The Collector v. Hubbard*, 12 Wall. 1. The position that a stockholder in a corporation has no interest in the enhanced value of its property or in its undivided income, gains, profits or surplus until a dividend thereof is declared is untenable and may not prevail.

It is admitted by the demurrer that in this case the value of the property of the corporation increased solely by reason of the advance in the value of its timber lands from $1,500,000 in 1903 to $3,000,000 on March 1, 1913, that the value of the stock of the plaintiff from the same cause proportion-

ately increased from $79,975 in 1903 to $159,950 on March 1, 1913, and that no farther increase of value, gain, income or profit resulted before or by reason of the sale of all the property of the corporation in March, 1914, and the distribution of its proceeds among its stockholders.

The Income Tax Law of 1913 provides: "That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year a tax of 1 per cent. per annum." Par. A, Sub. 1.

> "In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum." . . . "All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of Paragraph A, shall apply to the levy, assessment and collection of the additional tax imposed under this section." Par. A, Sub. 2.
>
> "That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent." Par. B.

After specifying the exemptions and deductions, allowed

in the computation of the net income for the purpose of levying the normal tax, the law declares that:

> "The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: Provided, However, That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive."

All the value of the property of the corporation and all the value of the stock of the plaintiff, whether it was due to capital assets, or income, or gains, or profits, or all of these combined, had arisen and accrued and had become their property before March 1, 1913. Words in a statute ought not to be given a retrospective operation unless they are so clear, strong and imperative that no other meaning can be annexed to them or unless the intention of the legislature cannot be otherwise satisfied. *United States v. Burr*, 159 U. S., 78; *United States v. American Sugar Co.*, 202 U. S., 563, 577. The provisions of this law that the normal tax shall be levied annually upon the net income arising or accruing in the preceding calendar year, that so far as this case is concerned all the provisions relative to the levying of the normal tax shall apply to the levying of the additional tax, that the normal tax shall be computed on the remainder of the net income of each person accruing during each preceding calendar year ending December 31st, except that for the year ending December 31, 1913, it shall be computed on the net income accruing from March 1st to December 31st, leave no doubt that the Congress intended to and did exclude from the burdens of the taxes it imposed by the Income Tax Act of October 3, 1913, all income, gains and profits of every kind which had arisen or accrued prior to March 1, 1913. It clearly intended to leave and surely did leave all the income,

gains and profits which had accrued or arisen prior to that date whether they were in the form of divided or undivided surplus, income, gains or profits as free from every income tax it imposed and as absolutely the property of their respective legal and equitable owners as was any of their original capital or property. Now, the subsequent change by sale, distribution or otherwise of the form of property held on March 1, 1913, without thereby enhancing its value or causing any gain, profit or income to its holders, as from real to personal property, or from stock to cash, does not subject it to the income tax because it produces no gain, profit or income; it leaves the value of the property the same after as before the change. And as the sale of the property of the Payette Company in 1914 and the distribution of its proceeds to its stockholders by the dividend did not enhance the value of the property of the corporation or of the stockholders or produce any gain, profit or income for them, but left the value of their property the same that it was before those transactions and the same as it was when the Income Tax Law took effect, the declaration and payment in 1914 of the dividend by which the proceeds of the sale of the property of the corporation were distributed to its stockholders did not transform the increased value of the plaintiff's stock which had accrued and arisen prior to March 1, 1913, into income, gains or profits accruing or arising subsequent to that date and did not subject it to any income tax. *Merchants Ins. Co. v. McCartney,* 17 Fed. Cases 46, No. 9443; *Bailey v. R. R. Co.,* 22 Wall. 604, 106 U. S. 109, 114; *United States v. Smith,* 27 Fed. Cases 1175 No. 16, 341; *Von Baumbach v. Sargent Land Co.,* 219 Fed. 31, 36, 37, 134 C. C. A. 649, 654, 655; *Sargent Land Co. v. Baumbach,* 207 Fed. 423, 430, 432, 434; *Mitchell Bros. Co. v. Doyle,* 225 Fed. 437, 439, 440; *Doyle, Collector v. Mitchell Bros. Co.,* ..... C. C. A. ..... Fed. ..... (6th Circuit), filed June 30, 1916; *Chicago, Bur. & Q. R.*

Co. v. Page, 1 Biss. 461, 5 Fed. Cases 600, No. 2668; *Reynolds v. Williams,* 20 Fed. Cases 625, No. 11, 734, 4 Biss. 108.

The third argument of counsel for the collector is that because Paragraph B provides that: "The net income of a taxable person shall include gains, profits and income derived . . . from interest, rent dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever," all surplus or undivided profits included in any dividend received after March 1, 1913, although they accrued and aro. . years prior to that date, are by these terms of the law subjected to the additional tax, and he cites in support of this conclusion *Van Dyke v. City of Milwaukee,* 159 Wis. 460, 146 N. W. 812; and *United States v. Cleveland, C. C. and St. L. Ry. Co.,* a decision of the District Court of Ohio filed February 23, 1916. Conceding that these two decisions sustain this proposition of counsel for the government, they are not controlling and have not proved persuasive. In Van Dyke's case Judge Barnes filed an able dissenting opinion which has proved more convincing and which is in accord with the decision of the Supreme Court in *Gray v. Darlington,* 15 Wall. 63, and with the weight of authority. It was, as we have seen, the general purpose of Congress and the general effect of the Act of October 3, 1913, to impose an annual tax upon incomes, gains and profits accruing subsequent to March 1, 1913, and to impose none upon those which accrued or arose before that date. The interpretation of the clause of the act under consideration which brings within its grasp all incomes, gains and profits accrued before the effective date of the act which happen to form parts of dividends declared after that date flies in the teeth of the general purpose and policy of Congress in enacting the statute, creates an exception to the general effect of the statute which is not clearly made by the act itself and constitutes a strained and unnatural construction. Such a construction should not be adopted unless the terms of the act imperatively require it. The natural and

legal presumption is that Congress intended to treat all income, gains and profits accruing prior to March 1, 1913, alike and as it excluded from the burden of the income taxes all such income, gains and profits as accrued prior to March 1, 1913, that did not become parts of dividends declared after that date the presumption is that it intended to exclude those also. Not only is there nothing in the act to negative or overcome this presumption, but the terms of the law when carefully read sustain it. By the terms of the clause on which counsel relies the taxable net income there specified does not include all dividends received after March 1, 1913, or all proceeds of such dividends, but "gains, profits and income derived" from dividends. The clause is treating of the net income on which the additional tax is to be levied. By subdivision 2, Par. A, all the provisions of the section relating to individuals who are chargeable with the normal income tax, so far as they are applicable and are not inconsistent with that subdivision, are made to apply to the levy, assessment and collection of the additional tax. Two of the provisions of that section relating to individuals who are chargeable with the normal tax which are applicable to the levy, assessment and collection of the additional tax and are not inconsistent with the provisions of subdivision 2 are (1) that there shall be levied, assessed, collected and paid annually "upon the entire net income accruing from all sources in the preceding year a tax of one per centum per annum," and (2) that the tax shall be computed upon the remainder of net income "Accruing during each preceding calendar year ending December thirty-first: Provided, however, that for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen." All these provisions of the act must be read and construed together and when so read and interpreted there is no logical or rational way of escape from the conclusion that the "gains, profits and income derived"

from dividends charged with the additional tax by Par. B are the gains, profits and income arising and accruing subsequent to March 1, 1913, derived from dividends and those only. And the conclusion is that the proceeds of the enhanced value of the stock of the plaintiff which accrued and arose prior to March 1, 1913, from the gradual increase in the value of the timber land of the Payette Company and which formed a part of the dividend made by that company in 1914 was not subject to the additional income tax under the Act of October 3, 1913. This conclusion finds substantial support from another consideration. The words income, gains, profits are used in common parlance and as legal terms in contradistinction to capital, property, capital assets. The enhanced value of the land or property of a corporation or of the stock of a corporation which slowly accrues through a series of years from the natural and gradual increase of the value of the timber land or other property which the corporation holds without trading is more analogous to property, capital or capital assets than to income, gains or profits. It is rather a growth, an increase of the property or capital assets than income, gains or profits produced by the property. Adverting to the oft-quoted analogy declared by the Supreme Court of Georgia in *Waring v. Savannah*, 60 Ga. 100, that "The fact is, property is the tree, income is the fruit; labor is the tree, income the fruit; capital the tree, income the fruit," the enhanced value of property from the slow and gradual increase of its value through a series of years is rather a growth of the tree than the production of its fruit. It is so inequitable, so unjust, so discriminatory to treat such an enhanced value accruing through many years before the enactment of an income tax law as the income, gains or profits of the year in which it happens subsequently to be distributed that the following rule which is supported by the more forcible reasons and by the great preponderance of authority has become the established law in the federal courts. The enhanced value of property which accrues from the gradual in-

crease in its value during a series of years prior to the effective date of an income tax law, although divided or distributed by dividend or otherwise subsequent to that date does not become income, gains or profits taxable under such an act. Such enhanced value, like the property of which it is an outgrowth and in which it adheres, becomes the absolute property of its legal and equitable owners before the effective date of the law and as against such a law thereafter remains their capital assets. *Gray v. Darlington,* 15 Wall. 63, 65, 66, 67; *Sargent Land Co. v. Von Baumbach,* 207 Fed. 423, 432; *Von Baumbach v. Sargent Land Co.,* 219 Fed. 31, 36, 37, 134 C. C. A. 649, 654, 655; *Gauley Mountain Coal Co. v. Hays,* 230 Fed. 110; *Industrial Trust Co. v. Walsh,* 222 Fed. 437; *Mitchell Bros. Co. v. Doyle,* 225 Fed. 437, 439, 440; *Doyle v. Mitchell Bros. Co.,* C. C. A. , Fed. , (6th Circuit), filed June 3, 1916; *Hudson's Bay Co., Ltd., v. Stevens,* 25 L. I. R. 709, 5 Tax Cases 424, 436, 438, 439; *Tebrau (Johore) Rubber Syndicate, Ltd., v. Farmer,* 47 Scot. L. R. 816, 5 Tax Cases 658.

Because no income, gains or profits accrued to the plaintiff during the year 1914, or after March 1, 1913, but during that time his property remained of the same value and because the sale of the property of the Payette Company in 1914 and the distribution of its proceeds by a dividend to its stockholders was but a change of the form without any increase of the value of the property he owned before the Income Tax Law of 1913 took effect there was no error in the judgment below and it is affirmed. [Not yet officially reported.]

[Comment.]

The judgment of the Court below in Lynch *vs.* Hornby, which presented the same questions considered and determined in Lynch *vs.* Turrish, supra, and with which it was submitted, on the appeal of the Government, was affirmed, Judge Sanborn delivering the opinion of the Court. Filed September 4, 1916. [Not yet officially reported.]

Depletion of Natural Resources—Recording Depletion on Books.

Under the Corporation Excise Tax Law of 1909, the U. S. District Court, M. D. Pa., has held that a Coal Company was entitled to a deduction of 15 cents for each ton mined as an allowance for depletion. The fact that this amount was incorrectly carried on the books of the Company in surplus account instead of as depletion reserve did not justify the government in disallowing the deduction. (Forty Fort Coal Co. *v.* Kirkendall, Collector, 233 Fed. 704.)

UNITED STATES CIRCUIT COURT OF APPEALS,
EIGHTH CIRCUIT.

No. 4652, September Term, A. D. 1916.

E. J. LYNCH, *Collector of Internal Revenue for the District of Minnesota, Plaintiff in Error,*

vs.

H. C. HORNBY, *Defendant in Error.*

In Error to the District Court of the United States for the District of Minnesota.

Mr. Alfred Jaques, U. S. Attorney, appeared for plaintiff in error.

Mr. A. W. Clapp (Mr. N. H. Clapp, Mr. H. Oldenbur, and Mr. Harold J. Richardson, were with him on the brief), for defendant in error.

Before Sanborn, Adams, and Carland, Circuit Judges.

SANBORN, *Circuit Judge,* delivered the opinion of the court:

The writ of error in this case challenges a judgment which Hornby, the plaintiff below, recovered against Lynch, the collector, for the return to him of $171 which the collector had assessed against him as an additional income tax under the Tariff Act of October 3, 1913, C. 16, Sec. II, 38 Stat. 166; 3 U. S. Comp. Stat. 1913, Secs. 6319, 6320, 6321, and which he had paid under protest. The facts were alleged in the complaint of Hornby and they were admitted by demurrer. They are set forth in detail and are numerous, but the result of them is that Hornby was the owner of 434 shares of the capital stock of the Cloquet Lumber Company from 1906 until 1916. That company was a corporation of Iowa which for more than a quarter of a century has been engaged

in purchasing timber lands, manufacturing the timber into lumber and selling it. It had a capital stock of $1,000,000 divided into 10,000 shares of the par value of $100 each. On March 1, 1913, by the increase of the value of its timber lands and by its business operations it had become possessed of property which was worth four times the par value of its stock or $4,000,000, its timber had become worth ten dollars per thousand feet and the stock of Mr. Hornby, the par value of which was $43,400, had become worth at least $150,000. In the year 1914 the Cloquet Company was engaged in converting its standing timber into money and distributing it among its stockholders by cutting the timber, manufacturing it into lumber and selling the lumber. In that year it distributed to its stockholders in dividends $650,000. Of these distributions $240,000 or 24% of the par value of its capital stock was derived from the net earnings and profits of the company during the current period and $410,000 was derived from moneys realized during the year 1914 by the Cloquet Company from the conversion into money by it of property which it owned, or in which it had an interest, on March 1, 1913. Hornby received during the year 1914 $10,416 from the distribution of these net earnings and profits of the company and $17,794 out of the distribution of these moneys realized from the conversion into money of the property which the Cloquet Company owned or had an interest in on March 1, 1913. The property out of which the $410,000 was realized was of the value of $410,000 on March 1, 1913, and the conversion of it into money and the distribution thereof diminished the value of the Company's property as it was on March 1, 1913, by that amount and dimished the value of Mr. Hornby's stock as it was on March 1, 1913, and increased his cash $17,794. In his income tax return for the year 1914 Mr. Hornby included the $10,416 he received out of the income and profits of the Cloquet Company during that year and he paid an income tax without protest upon a computation which included this amount, but he did not include the $17,794 which he received out of the

moneys realized in 1914 by the Cloquet Company from the conversion into money of property which it owned or had an interest in on March 1, 1913. The Commissioner of Internal Revenue deemed this $17,794 taxable income to Mr. Hornby and on account of it levied an additional tax of $171 which Mr. Hornby paid under protest and brought this action to recover.

Counsel for the United States complains that the complaint does not state facts sufficient to constitute a cause of action because it does not state the original cost of the timber or other property which the Cloquet Company acquired before and owned on March 1, 1913. But that omission is immaterial because it does state the value of the property which that Company owned and was interested in on March 1, 1913, which was converted into money and distributed to its stockholders in 1914 and that this conversion and distribution diminished the value of its property as it was on March 1, 1913, and as it was just before the conversion and distribution by $410,000 and diminished the value of Mr. Hornby's stock as it was on March 1, 1913, and as it was just before the sale and distribution by $17,794. As none of the property which the Cloquet Company or Hornby held on March 1, 1913, whether it was original capital or previously earned surplus, income gains or profits, was intended to be made or was made taxable as income by the Income Tax Law of 1913, the complaint stated facts sufficient to show that this $17,794 was not so taxable.

This case was tried in the court below and was argued and submitted to this court with the case of Lynch *v.* Turrish, the opinion in which is filed herewith. With the exception of the contention which has just been considered it presents the same questions considered and determined in that case. For the reasons stated in the opinion in Lynch *v.* Turrish, and because no income, gains or profits accrued to Mr. Hornby during the year 1914, or at any time after March 1, 1913, by reason of the conversion into moneys and distribution in

the year 1914 of that portion of the property which the Cloquet Company owned or owned an interest in on March 1, 1913, from which it realized the $410,000 in 1914, but the effect of that conversion and distribution was simply to change the form in 1914 of a part of the property which Mr. Hornby owned on March 1, 1913, while its value remained the same, the $17,794 which he received in dividends from that conversion and distribution was not subject to any income tax under the Income Tax Law of 1913 and the judgment below is affirmed.

Filed September 4, 1916.

A true copy.

Attest:

[SEAL.] ——— ———,

Clerk U. S. Circuit Court of Appeals,
Eighth Circuit.

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